Enterprise Investment Scheme (EIS)

A Guide For Compliance Managers

1 What Is EIS?

EIS was first introduced in 1993/94, and replaced Business Expansion Schemes (BES). They are designed to stimulate investment in smaller, unquoted companies (currently defined as those with less than 250 employees, and assets under £15 million).

Since the Enterprise Investment Scheme (EIS) was launched, almost 26,355 individual companies have received investment through the scheme and over £16.2 billion of funds have been raised. (Source EIS Association, October 2017). Investment returns vary enormously, but the average return, on an unweighted basis, on all exits from the Calculus EIS Fund based on their current investment strategy, is 2x.

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2 Different Types Of EIS

There are generally three types of investments available to investors under EIS:

A. Single Company investments

The investment here is only into one company, often introduced to the investor via personal connections. As there is no spreading of risk these are deemed to be more risky than the other two types.

B. Portfolios of EIS investments

This is where a series of individual investments are made to create a portfolio of investments, on a bespoke basis. Investors are often active in deciding which investments to become involved in themselves.

C. EIS funds

Investors into an EIS fund will delegate the selection of investments to a specialist fund manager who will also manage the companies on their behalf. The investor benefits from the knowledge and experience of the fund manager in sourcing deals, carrying out due diligence and working with the companies to achieve a profitable exit.

EIS 'funds' are normally, in reality, a series of individual investments into individual companies with the fund manager holding discretionary investment management agreements with the respective investors in the fund. All the funds subscribed are managed according to a common investment mandate and each investor's participation in any investment is pro rata to his or her subscription to the fund. Exceptions to this principle can be made, for example, to exclude investors who work for accountancy firms where a conflict of interest would arise. EIS funds are excluded from the definition of collective investment schemes and are governed under separate Treasury rules.

Due to the discretionary investment management structure of the agreements, managers must hold regulatory permissions to manage investments. Clients will either be retail investment clients or professional clients as defined under COBS Rules – and can be treated as elective professional clients only if they meet strict criteria of expertise, experience and knowledge set out in COBS 3.5.3.

A critical point is whether the fund is approved or unapproved. This is not a regulatory term and one type is not 'better' than the other; it applies to HMRC registration.

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The term is however an indication of the date of when income tax relief can be claimed. For approved funds, 90% of the funds raised must be invested within 12 months, as such income tax relief can be claimed according to the date of the fund close and determines the date when income tax relief can be claimed. For unapproved funds, you have greater flexibility in putting the money to work as well as offering a greater deal of flexibility to investors claiming income tax relief as they can also take advantage of carry back provision. To be classed as HMRC approved, the EIS prospectus must be reviewed by HMRC.

If an approved fund invests at least 90% of its assets in approved investments within the 12 months following fund closing, investors in the fund will be treated as having made the EIS investments as at the date the fund closes.

However, the majority of EIS funds are 'unapproved' as this offers a more flexible approach.

Tax relief for unapproved funds is granted at the time the underlying investment is made and the fund manager can make investments over two years.

Income tax relief can (under current legislation) be carried back to the previous tax year, so that it is available across two tax years (at 30%).

Seed EIS

Seed EIS was introduced in the Finance Act in 2012, and is designed to encourage investment into Start-Up companies. Because Start-Up companies are deemed more risky than more established companies, the tax relief offered by the government is more generous to compensate for the additional risk (50% Income Tax Relief rather than 30%).

The introduction of Seed EIS was in many ways an experiment by the government, to see what impact it might make. It has clearly been regarded as a success in that in the 2015 Budget it was confirmed by the Chancellor as being a permanent approved tax incentivised investment.

3 Government Intentions

Investing in smaller companies is commonly regarded as more risky than investing in larger companies, which is why the Government offers generous tax reliefs to investors. It is intended to encourage investment in new enterprises, and as a recompense for the risk that the investor is taking.

The tax benefits have been gradually enhanced over time and are now, under current legislation:

- Tax Free capital gains on gains made by the fund.
- Income Tax relief at 30% which can be taken in the tax year the Fund makes its investments or carried back to the previous tax year, where a sufficient tax liability is available to set against.
- Capital Gains Tax deferral of tax due on other capital gains up to the value of the investment for the life of the investment.
- Full Inheritance Tax relief is available through Business Relief provided the investments have been held for at least two years and are held at the time of death.
- Loss relief which can be taken as a deduction against income or as a capital loss and can give total tax relief on an investment of up to 61.5%. Loss relief can be claimed on any investment incurring a capital loss without being offset against investment achieving a capital gain which are free of CGT.

4 Benefits For Government

As far as the Government is concerned, smaller businesses are the businesses of the future, and will provide employment as well as social and other economic benefits. If these businesses grow, so will the taxes that are paid to the Government, whether through personal or corporate taxation.

As an illustrative example, Calculus Capital invested £5 million into a growing company. HMRC then gave income tax relief on the investment at 30% equating to £1.5 million to investors in that company via the fund. It is now estimated that after just 18 months the Government has received the £1.5 million back, through payroll taxes on new employees that have been paid by the company. This is precisely the scenario that the Government had in mind when it introduced the scheme.

5 What The Government Dislikes

Over the past couple of years the Government has imposed restrictions on some EIS schemes. First of all, EIS investment into solar schemes have been stopped as investors were benefitting from two separate tax breaks, which made the scheme too generous for investors!

The Government has also made it clear that it is not keen on schemes where the only effective return to investors is the tax relief. It is looking for an element of risk within the investment in order to justify giving the tax relief.

These limitations should be considered in context. EIS schemes that are evidently run well are clearly supported by the Government, and are one of the few tax efficient investment schemes remaining as the Government has closed unintended loopholes.

The budget in November 2017 introduced new rules designed to prevent EIS tax reliefs being given on investments with a low or negligible risk to capital (often called capital preservation schemes).

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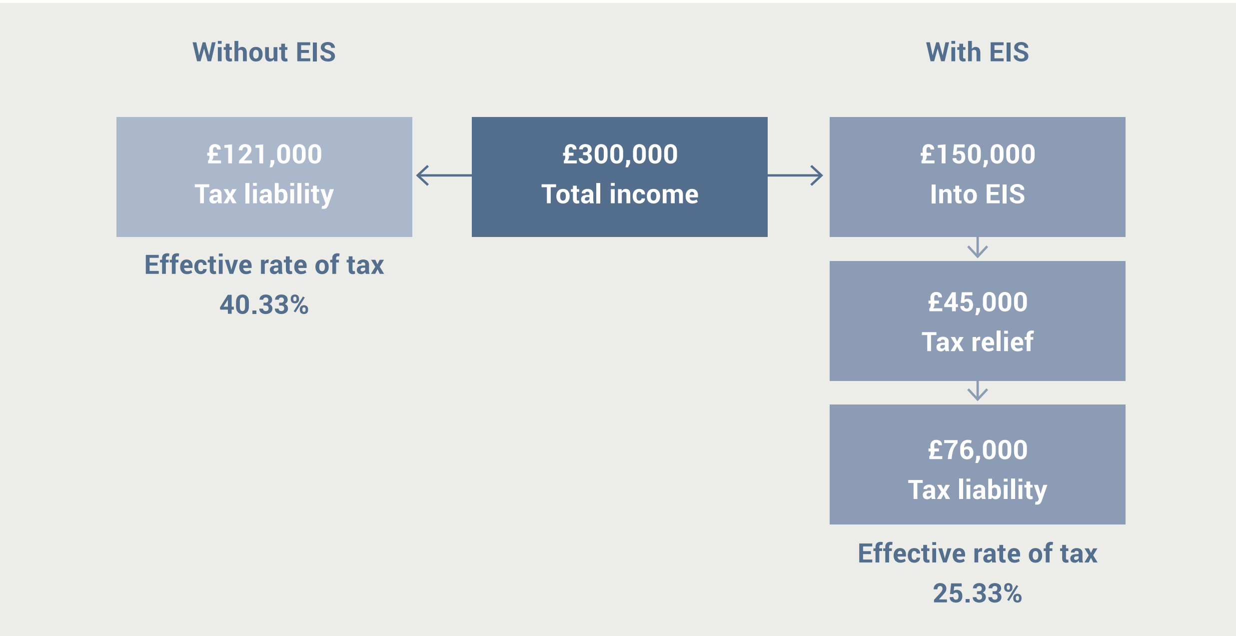
6 Case Studies – EIS In Practice

Example One: **High Earner Looking for Income Tax Relief**

- Client has a very large income tax liability for the previous tax year as well as a large one for the current year.
- Client has maximum funded pension and ISA allowances, and is a 45% tax payer.
- Client is looking to reduce their tax liability
- Client has a total income of £300,000, which generates a tax liability of £121,000
- Or the client can invest £150,000 into an EIS, which generates tax relief of £45,000
- Client has full value of EIS investment tax free after 3 years
- The investment has Business Relief qualifying status after 2 years

These case studies are illustrative and do not include charges

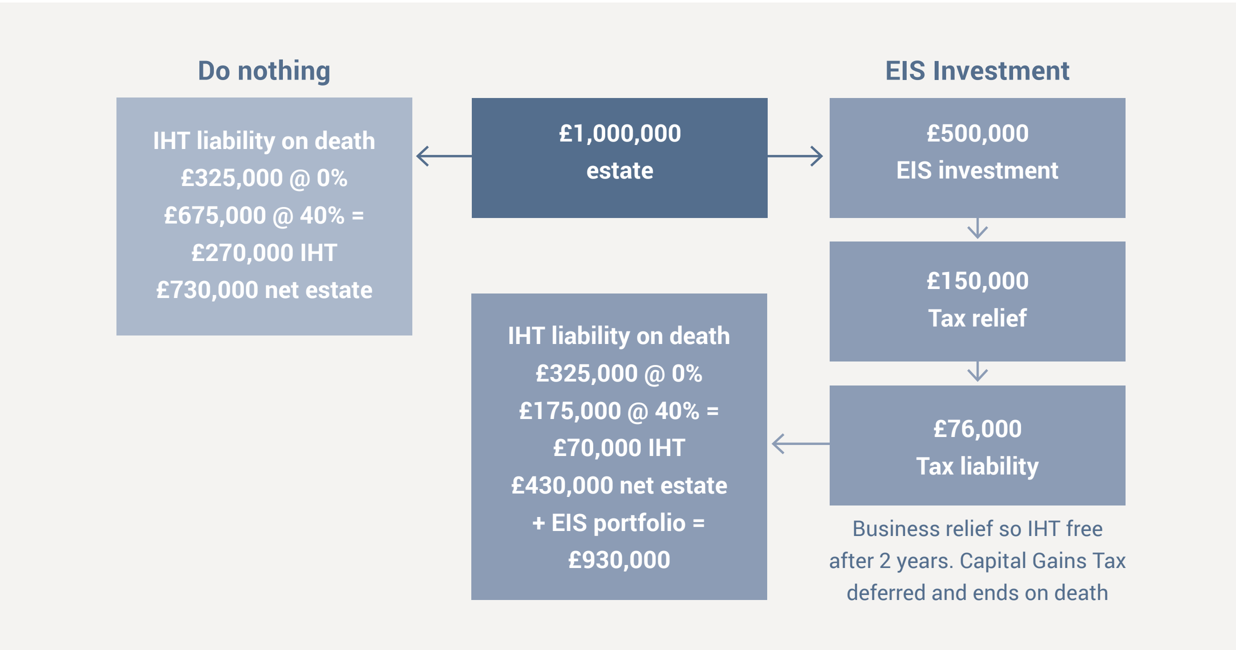


Note: **Income tax relief can be**

- Carried back to previous tax year
- Used in the year the underlying investments are made
- A combination as appropriate

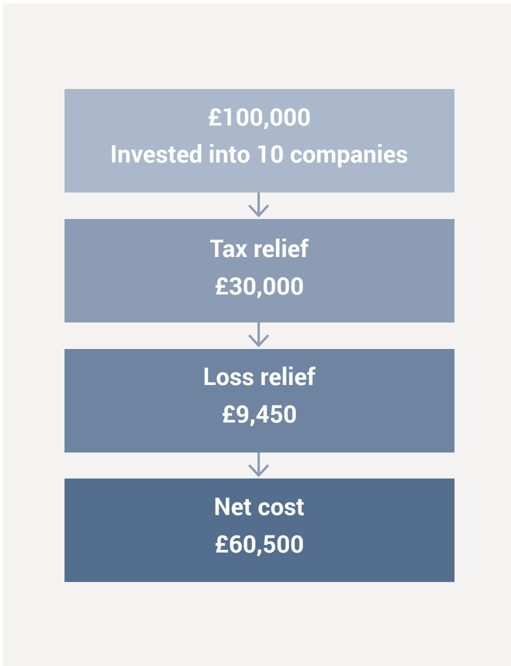
Example Two: **EIS for IHT Planning**

- A retired high net worth individual has non pension assets of £1,000,000
- Selling assets can trigger capital gains, and will still be part of the estate for IHT purposes
- The client wants to retain control of the assets rather than gift them away at this stage



Example: **Loss Relief When Some Companies Fail**

- An EIS client has a range of 10 companies in their portfolio. There was an initial investment of £10,000 into each one. They are a 45% tax payer
- Net cost after 30% tax relief is £70,000.
- Three investments fail and are written down to £0
- Three investments achieve 2½x in value on exit
- Four investments achieve initial cost on exit
- The client can claim loss relief against the net cost of the three failed companies, and offset this against Income Tax = £9,450
- Net cost of investment is £60,550



Example investment returns for each company

1	2	3	4	5	6	7	8	9	10
£0	£0	£0	0.75x £7,500	0.75x £7,500	0.75x £7,500	0.75x £7,500	2.5x £25,000	2.5x £25,000	2.5x £25,000

Total Return = £105,000

The net cost to the investor of £60,500 gives a post loss return of just under 2x

7 The Regulatory Framework

- Most EIS "funds" are not, strictly, funds: investors do not purchase units in a fund, but acquire shares in each of the companies that the "fund" invests in. Thus EIS are generally operated as collective portfolio management arrangements.
- When operated as collective portfolio management arrangements, EIS are not UCIS, nor are they "non-mainstream pooled investments" (COBS 4.12).
- EIS are not "retail investment products". Thus, firms positioned as independent financial advisers are not obliged to include EIS in their analysis of the relevant market (COBS 6.2A).
- Since they are advising on the EIS scheme rather than on the individual shares that the scheme might invest in, investment advisers wishing to recommend EIS are not required to have a qualification for "advising on securities".
- Investment intermediary firms (whether IFA or restricted advisers) need only the standard permissions to advise on and arrange investments, in order to advise on EIS. It is not necessary to have opted into MiFID. The COBS Rules do not contain any specific requirements relating to EIS sales, and there is no FCA requirement for EIS sales to be peer-reviewed or pre-approved.
- EIS are not "retail investment products" and thus are not subject to the adviser charging regime. However, most EIS providers are willing to facilitate customer agreed remuneration as an alternative to their standard rate of commission.
- From 1 January 2018 firms that manufacture, advise on or sell investment products that fall within the scope of the PRIIPs Regulation will need to produce, publish or provide Key Information Documents (KIDs) for packaged retail products, such as funds, insurance-based investments, structured products, derivatives and investments issued by some special purpose vehicles.
- EIS should not be sold to "US Persons" (i.e. anyone who is a US citizen or is US resident for tax purposes) because the US Internal Revenue Service would seek to claw back the tax relief.

8 Risks

- EIS investments must be held for at least 3 years to achieve the tax benefits.
- In practice, allowing for the additional periods of time required to identify suitable investee companies, and to effect an exit, a period of at least 5 to 7 years may be needed. EIS should therefore be regarded as a long term investment.
- EIS investments are illiquid. It would be difficult to effect an early encashment of an EIS investment, and may be impossible.
- The valuation of EIS investments (which are mostly unquoted) is a matter of judgement.
- EIS investments are in smaller, start-up or growth phase enterprises, and carry a higher risk of failure than other forms of investment such as unit trusts or quoted equities (although the tax benefits do include loss relief on failed investments).
- FSCS will not compensate investors in the event that an investee company fails (although investors would be covered in the event of a claim against the IFA recommending the scheme, or the EIS manager, if the IFA or manager were to fail).
- Investors will be eligible to take to FOS a complaint about the IFA recommending the scheme, or the EIS manager, unless the investor has been categorised as an elective professional client (COBS 3.5).
- It is not generally technically possible to produce past performance tables (as in COBS 4.6.4) for EIS, because most EIS are not 'funds' with a unit price.
- EIS are unlikely to be used for money laundering. Not only are they long-term and illiquid, but investors have to report EIS investments to HMRC in order for the tax reliefs to be obtained.
- EIS schemes cannot use borrowing to gear up their investments. So the investor is never exposed by more than his/her original investment.

9 Who Is EIS For?

EIS investment is generally most suitable for high net worth or sophisticated investors, who understand the risks involved, and are prepared to accept these risks in return for a potentially higher reward. They are only attractive for investors who have significant potential tax liabilities to relieve.

EIS is increasingly used for tax planning as the Government has removed or limited other tax efficient investments. This tax planning can encompass Income Tax, Capital Gains Tax and Inheritance Tax.

Other than the tax benefits, EIS can also be seen as growth investments in their own right, which in general only have a low correlation with public markets and other assets classes.

Because the EIS investment is Illiquid, and is not accessible until an exit is made, it is only for people that can tie up this capital for 5-7 years.

10 Your Due Diligence

You might like to consider the following pointers in conducting your own due diligence:

Management Experience

Does the fund's management team have a proven track record of investing in unquoted companies? Investing in EIS-qualifying companies differs greatly from investing in listed companies, as most publicly traded companies require analyst coverage and therefore scrutiny of business performance is high. Can the fund's management spot - and help sustain - "winners"?

Independent Reviews

There are several companies that offer independent reviews of most, if not all, EIS funds:

- Hardman & Co
- MICAP
- Tax Efficient Review, from Martin Churchill
- Tax Shelter Report, from Allenbridge

We recommend that you consider subscribing to at least one of these, so that you can benefit from their research and analysis. For some advisory firms, independent analysis is now a requirement of their compliance process.

Theme - generalist or specialist

Some EIS funds are generalist, others invest in a single sector, like clean tech or media, and a few are very esoteric; some managers prefer start-ups while others favour more established businesses. Get a firm handle on an EIS fund's investment strategy to ensure it meets your client's risk profile, investment sector preferences and time horizons.

Deal flow

Deal flow is the life blood of any Fund Manager. How many opportunities does the fund manager screen per year, what is their screening process and where do their deals come from?

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> The Manager's steadfast emphasis on mature companies is likely to continue appealing to investors looking for the potential of capital appreciation within a diversified, generalist portfolio offered by an established tax-efficient Manager.

Allenbridge – Calculus EIS Fund, November 2017

Due Diligence and Investment Monitoring

Does their due diligence (DD) process impress you?... Good EIS fund managers will perform thorough and robust due diligence to assess the financial health and management of all the companies they are considering. How close does the fund manager stay to the investee company post investment?

Successful managers will continue to carefully monitor underlying investments throughout the period of investment until exit. This is to ensure that the strategy remains in line with the objectives. A manager may monitor monthly management accounts, speak regularly to senior management and/ or appoint representatives to the boards of investee companies.

Exits

Investigate the manager's track record on exiting investments. How does the manager approach exits? What is the likely exit time frame? Getting a handle on the exit strategy is key to understanding how and when investors may be able to get their money out.

Performance

Find out what the performance of the fund managers has really been. Are they showing a consistent record of good performance? But remember that past performance is not indicative of future returns.

11 Where To Go For Further Information

At Calculus Capital, we would be delighted to help with further information or training on EIS.

In the first instance please contact Claire Olsen, Director - Head of Investor Relations on **020 7493 4940** or at **claire@calculuscapital.com**.

Alternatively you might like to contact the EIS Association at **www.eisa.org.uk**, or

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Information as at 11 May 2018