



Tax relief for business angels

Investing in shares – tax considerations

If you are an individual making an investment in shares, there will be many factors to consider, relating to both the commercial and financial aspects of the transaction as well as tax. The main tax considerations will normally be stamp duty on the purchase, income tax on dividends and the capital gains tax (**CGT**) treatment of any subsequent sale of the shares. In this context, the UK's tax system includes two special tax regimes designed to encourage investment by individuals in smaller unquoted trading companies (either directly or indirectly through a corporate vehicle) by making various tax reliefs available. These regimes are the Venture Capital Trust (VCT) scheme and the Enterprise Investment Scheme (**EIS**) and this information sheet is intended to provide a brief guide to how these schemes operate.

Enterprise investment scheme

Broadly speaking, the EIS makes two reliefs available to individuals who subscribe for shares in qualifying EIS companies: income tax relief and CGT deferral relief. In addition, where income tax relief has been obtained, any capital gain realised on a subsequent sale of the relevant shares, is exempt from CGT. An investor will only be eligible to claim these reliefs where the investment is made by way of a subscription for ordinary shares, issued fully paid up in cash, in a qualifying company. To claim these reliefs, there is a minimum investment of £500 in any one company in any given tax year.

Companies That Qualify For EIS investment

In order to qualify for EIS investment, the company must satisfy a number of stringent criteria regarding, for example, the nature of its activities, the amount of money that can be raised through the EIS and how the funds are used. In addition the scheme restricts investment to companies which come within certain financial limits.

Under the EIS rules, perhaps the most important requirement is that a company will only qualify if it uses the funds raised to finance a qualifying trade or for research and development expected to result in such a trade. The rules on the types of trade which qualify for this purpose are quite restrictive and it should be borne in mind that there is a long list of activities which are explicitly excluded. Amongst other things, the company must also:

- be unquoted and not controlled by another company (although the reliefs are available if the investment is made in the holding company of a qualifying EIS company in certain limited circumstances)
- have gross assets which do not exceed £7 million immediately before the issue of the EIS shares or £8 million immediately after, and
- have fewer than 50 employees

In addition, a company cannot raise more than £2 million in any 12 month period jointly from the EIS, VCT or Corporate Venturing Scheme. If any share issue breaks that limit, none of the investors in that issue will be able to claim any of the EIS tax reliefs.

Income tax relief

the income tax relief available is 20% of the cost of the shares and this amount is set against the individual's income tax liability for the tax year in which the investment is made. The maximum relief that can be claimed is £400,000 (giving a maximum tax reduction of £80,000 in any given tax year). There is a limited facility to carry back this relief to the previous tax year but relief cannot be carried forward to later years. The relief may also be withdrawn if the shares are sold or otherwise disposed of before the minimum holding period is reached. This means that the shares must usually be held for at least three years although it can be longer in certain circumstances.

It is important to note that an investor will not normally be eligible for income tax relief (and the relief can be withdrawn) if s/he is or becomes connected with the company during the period beginning two years before and ending three years after the initial investment. In this context, an individual can be connected with a company by holding more than a 30% stake or by being an employee, partner or director. There is, however, a limited exception to this connection test for "business angels" – generally, those who wish to become directors of the company and make their expertise available to it. In such cases, but subject to certain restrictions, tax relief will be available even though such individuals may be receiving payment for their services.

CGT exemption on disposals

if an individual has received income tax relief (which has not subsequently been withdrawn) on the cost of shares and the shares have been held for the minimum holding period (normally, three years), any capital gain on their subsequent sale will be free from CGT.

If the shares are disposed of at a loss, the amount of the loss less any income tax relief given can be set against income in the year that the shares are disposed of instead of being set off against capital gains.

CGT deferral relief

the payment of tax on a capital gain can be deferred where the amount of gain is, effectively, reinvested in shares in an EIS qualifying company. In order to qualify for the relief, the investment must be made within the period of one year before and three years after the relevant gain arose. There is no minimum holding requirement for the EIS shares: the gain is simply deferred until shares are sold or otherwise disposed of. (Note that if the CGT reforms, referred to below, are enacted in their current form it will only be possible to claim frozen indexation allowance in respect of any deferred gain (if any). Taper relief will not be available.)

HMRC provide a useful introductory guide to the EIS which is available via the following link:
www.hmrc.gov.uk/eis/index.htm

The VCT scheme

This scheme is designed to encourage individuals to invest, indirectly, in smaller, unquoted, trading companies, by investing through a venture capital trust or VCT. A VCT is a listed company run by fund managers which has been approved by HMRC. In order to obtain HMRC approval, the VCT must make most of its investment in qualifying companies. To qualify, the companies that are invested in must satisfy requirements similar to those applicable in respect of EIS investments.

Income tax relief

Relief is available at the rate of 30% of the amount subscribed for new VCT ordinary shares. This amount can be set against the individual's income tax liability in the tax year in which the shares are issued but there are no provisions for the relief to be carried forward or back to other tax years. The relief is also capped by reference to a maximum investment in VCT shares of £200,000 in any given tax year.

The relief may only be claimed by an individual who has subscribed for shares in the VCT (ie it is not available if the VCT shares are purchased in the market) and the shares must be held for at least five years. If the shares are disposed of within five years of their issue, the individual will have to repay some of the income tax relief.

Exemption from tax on dividends

There is an exemption from income tax on dividends received from ordinary shares in VCTs (whether the shares have been issued to the investor or acquired in the market) subject to certain conditions including an annual acquisition limit of VCT shares of £200,000.

CGT exemption on disposals

There is no CGT to pay on the disposal of VCT ordinary shares (whether the shares were acquired by way of a subscription for new shares in the VCT or otherwise). Again this relief is only available in respect of shares acquired within the annual acquisition limit of £200,000.

(NB CGT deferral relief in respect of VCT shares was abolished in respect of shares issued after 5 April 2004.)

HMRC's guidance on the VCT scheme can be found at www.hmrc.gov.uk/guidance/vct.htm

Entrepreneur's relief

If an investment does not qualify under the above schemes, a subsequent disposal of the shares will normally be subject to CGT. As announced in the Pre-Budget Report in October 2007, there will be major changes to CGT from April 2008. For disposals of capital assets on or after 6 April 2008, there will be a single rate of CGT of 18% which will apply to individuals, trustees and personal representatives. The tax-free annual exempt amount (currently £9,200) will remain, but taper relief and indexation allowance will be withdrawn completely.

Investors who become involved more closely with the business in which they have invested (for example, by becoming a director) may be able to take advantage of the new 'entrepreneur's relief'. This relief is intended to apply to disposals of shares on or after 6 April 2008 with the aim of benefiting owner/managers of small businesses and business angels who take a 5% holding in the company concerned.

The Government's proposal is that, with effect from 6 April 2008, the first £1 million of gains that qualify for entrepreneur's relief will be charged at an effective 10% rate (although gains in excess of this amount will be within the new 18% regime). However, the relief will only apply:

- to disposals of the whole or part of a trading business (not including a property letting business other than furnished holiday lets), or
- to disposals of shares and securities in a trading company **but only if** the shareholder making the sale:
 - has been an officer or employee of the company or another company within the same group, and
 - owns at least 5% of the ordinary share capital of the company giving him at least 5% of the voting rights.

These conditions need only to be met for one year for the relief to apply.

Other tax issues

As with all investments in shares, there will be other tax issues to consider, for example:

- **Stamp duty:** As far as stamp duty is concerned, the position is relatively straightforward. If the shares are issued directly to the investor, no stamp duty will arise. On the other hand, if the shares are purchased from an existing shareholder, a charge to stamp duty will usually arise at the rate of 0.5% of the total price paid for the shares and it is the purchaser that normally bears the stamp duty cost.
- **Tax on dividends:** Unless the VCT scheme dividend exemption applies, any dividends paid on the shares will normally be taxed as income. Dividend income that would otherwise be charged at the starting rate or basic rate is subject to income tax at the rate of 10%. For investors who are higher rate tax payers, dividend income that would otherwise be charged at the higher rate is subject to the dividend upper rate - currently 32.5%. There is also a non-refundable tax credit on UK dividends income equal to 1/9th of the amount of the dividend.
- **Employment income:** Another point to consider is whether the issue of shares could potentially be taxed as employment income where the investor is an employee of the company concerned.
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This note is only intended to provide a general guide to the types of tax issues that need to be considered when making an investment in shares. The tax treatment of any particular investment will depend on the precise circumstances of the individual making the investment. To find out how the above tax rules apply to you, specific tax advice should be sought.

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