The Venture Capital Schemes – An Overview

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The purpose of the Venture Capital Schemes is to provide funding for companies that are in the relatively early stage of the business cycle. At the time of writing, there are four separate schemes, each one offering generous tax breaks to investors as a reward for taking on the risks associated with this type of investment.

This article provides a commentary on the various schemes and is intended to complement the summary table of the tax breaks and some of the key conditions that need to be satisfied.

The table can be accessed from the following address:

http://taxnotes.co.uk/wp-content/uploads/2015/06/Venture-Capital-Schemes-Summary-of-Tax-Breaks-Table-June-2015.pdf

The table is best viewed by printing it out on A3 (large) paper and pasting it on the wall. The table has one empty column which is being kept free for the Social VCT that is to be introduced in the near future.

The Venture Capital Schemes – what are they?

There are four Venture Capital Schemes at present. The different levels of risk are reflected in the type of investment:

- **The Seed Enterprise Investment Scheme ("SEIS")** – is at the highest rung of the risk ladder. The word "seed" gives a clue – these are for companies still in the incubation stage. It can be thought of as a mini version of the next scheme which is:

- **The Enterprise Investment Scheme ("EIS")** – still risky, but lower down the ladder from SEIS;

- **The Social Enterprise Investment Scheme ("SITR")** – this is a version of the EIS Scheme that has been adapted to investments in social enterprises. The abbreviation "SITR" stands for Social Investment Tax Relief – guess why we don't use the abbreviation SEIS?

In all three schemes – which we shall call the Enterprise Schemes – investors subscribe for securities in a company in return for the tax breaks. One can invest in more than one company, subject to the annual limits. However, the following scheme provides a more efficient way of spreading risk:

- **Venture Capital Trusts ("VCTs")** – a VCT is a corporate vehicle that invests in other growth companies. It can be thought of as an EIS fund in the sense that the companies making up the portfolio are of a similar type to those seeking EIS funding. Investors access these companies indirectly by buying shares in the VCT;

And finally (let's hope!):

- **Social Venture Capital Trusts ("Social VCTs")** – this hasn't yet arrived on the scene. Social VCTs are intended to the equivalent of a VCT which invests solely in social enterprises. What the VCT is to the EIS Scheme, so will the Social VCT be to the SITR Scheme.

Although there are similarities between the various Venture Capital Schemes, there are also important differences.

The SITR Scheme – investing in social enterprises

This is the latest Venture Capital Scheme, introduced in 2014. At present, the scheme is temporary, applying to investments made between 6 April 2014 and 5 April 2019 (inclusive)[1]. However, there is the possibility of the scheme being made permanent[2]. This is similar to the position of the SEIS Scheme – this scheme was also temporary when it was first introduced in 2012, but has since been made permanent[3].

The other major difference between the SITR Scheme and the others is the fact that investors are permitted to invest in debt in addition to equities. Why is this the case?

The reason stems from the fact that a lot of social enterprises don't have ordinary share capital. For example, the organisation in question could be a company limited by guarantee or a charitable trust. In these circumstances, it makes sense to permit investors to subscribe for debt[4] – but note that the debt must be unsecured, and must rank lower than other types of debt in the event of a winding up[5]. This is consistent with the idea that the tax breaks associated with the Venture Capital Schemes are only offered in return for investors taking a risk with their hard earned money.

Upfront relief – Share subscription or second hand?

In order to access upfront income tax relief, the investment must be made directly, with the funds going straight into the company's coffers. So investors must subscribe for the shares or debt as the case may be – it isn't possible to buy the securities secondhand.

One point to make about the SITR Scheme and the special rules for debt investments. It is not necessary for the debt to be of the sort that requires a debt instrument to be issued in the way that equity is issued to investors. A straightforward loan will do, as long as the funds are advanced directly to the social enterprise – one cannot access the relief by taking an assignment of the debt from a third party[6].

Upfront relief – carry back rules

Each of the Enterprise Schemes has the facility to subscribe for securities in one tax year and carry back the relief against the previous year's income[7]. For example, with the EIS Scheme, one can subscribe for £2m worth of shares with:

- £1m allocated to the current tax year – this uses up the annual limit for the year;

- The remaining £1m is allocated to the previous year.

This example assumes that the investor hasn't used his previous year's allowance and that the limit for that year was also £1m. One also needs to take into account that the amount that one can carry back can also change – for example, before 2009/10 only half the amount could be carried back, as well as being subject to the relevant limit for the previous year[8].

Upfront relief – how does it interact with the other reliefs?

With the exception of VCTs, upfront relief is the key to accessing most of the other tax reliefs.

For example, in order to benefit from the CGT exemption, it is crucial that Enterprise Scheme investors claim the upfront income tax relief when originally subscribing for their securities[9]. Failure to do so will mean that they are liable to pay tax on any capital gains incurred when they eventually cash in on their investment.

However, for CGT reinvestment relief, the EIS and SITR Schemes don't require a claim for upfront relief, though the conditions attached are similar[10].

VCTs on the other hand, are in a class of their own. One doesn't need to claim the income tax relief in order to qualify for the dividend and CGT exemptions. In fact, these exemptions are available even if the shares have been bought second hand on the stock market.

In theory, one could claim upfront VCT relief, lose it, but still keep the other exemptions[11]. By contrast with the Enterprise Schemes, losing the upfront relief means losing (nearly) all the others.

Dividend exemption

There is no dividend exemption for the Enterprise Schemes, only for VCTs. However, this doesn't matter, given that the former types of investment are companies at an earlier stage of the business cycle – any earnings they do make are likely to be ploughed back into the business instead of being distributed to shareholders.

VCTs on the other hand are legally required to distribute at least 85% of their income to their shareholders[12]. So the dividend exemption makes sense. Note that this is not unrestricted. Investors buying up to £200,000 worth of shares in any tax year obtain the full benefit, but income generated from any extra shares are taxed in the normal way[13].

CGT exemption

All the Venture Capital Schemes have a CGT exemption. This would normally mean that capital losses are unallowable under general principles[14].

However, for the Enterprise Schemes, a capital loss can also be set against other capital gains. This is not the case for VCTs[15].

CGT reinvestment relief

This relief relates to capital gains incurred on other assets. It is possible to defer, or even extinguish part of the tax charge by applying the disposal proceeds to a venture capital investment. Only the Enterprise Schemes have this facility – VCTs used to have it, but it was abolished for the tax years 2004/05 onwards.

There are important differences between the schemes which have this relief:

- For EIS and SITR, the rolled over gain is deferred until such time that the relevant securities are disposed of. So, although the EIS/SITR securities themselves are exempt, this doesn't exempt the gain that has been rolled over into those securities[16];

- For SEIS, only 50% of the gain can be sheltered – however, this part of the gain is potentially exempt if the investor holds on to his SIES shares for the relevant three year holding period[17]. There is a special case for gains occurring in the tax year 2012/13. In this case the entire amount can be sheltered in this way[18].

Loss relief against income

Also known as share loss relief, this relief applies to investors who have subscribed for shares in an unquoted trading company. Provided the various conditions are satisfied, a capital loss on the shares can be set off against income[19].

There is a quirk in the legislation. The rules make a distinction between:

- EIS shares on the one hand – where the relief is made explicit[20]; and

- Other shares that constitute shares in a qualifying trading company[21].

There is no explicit statement that SEIS or SITR shares qualify. In principle they should qualify under the "other shares" heading, since the further conditions to satisfy appear similar to those applying for SEIS/SITR companies. However, one should be wary. It is possible in theory, for an investment to satisfy the SEIS/SITR criteria but fall foul of one of the conditions mentioned in the share loss relief rules – one needs to look closely at the legislation to confirm whether the relief will be available.

Note that for the SITR Scheme, the relief doesn't apply to losses on debt investments.

Shares held in VCTs don't qualify for the relief for a number of reasons:

- Share loss relief is directed at investments in unquoted trading companies[22] – VCTs do not satisfy this criteria. Not only are they quoted, they are not trading, but investment companies;

- More fundamentally, the words of the legislation specifically state that for the relief to apply, the investor must incur an allowable loss for CGT purposes[23]. But as we've just seen, losses on VCT shares are specifically unallowable. In short, if there's no loss relief against other capital gains, there can be no loss relief against income.

Inheritance Tax

These reliefs are not specific to the Venture Capital Schemes. They are a consequence of the rules on business property relief in the inheritance tax legislation.

The Enterprise Schemes qualify because they involve holding shares in unquoted trading companies. VCTs don't qualify as they involve quoted securities – the only way anyone can get relief in this case is to control the whole company, which is highly unlikely[24].

Conclusion

The summary table and above commentary should provide a guide as to what the tax breaks are, and the differences between the various Venture Capital Schemes.

However, one should note that the legislation does change quite frequently, and that therefore this can be no more than an overview – for example, the limits of how much you can invest in the schemes seem to keep changing over the years. One should always check for the latest updates in the tax news.

Furthermore, the conditions attached to the various tax breaks are a lot more numerous and complicated than is set out in the table – one should always bear this in mind if you are in the business of advising on these schemes. Hopefully, the statutory references in this article should provide some clue as to where to go to in the legislation.

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This article was first published on the website Tax Notes (taxnotes.co.uk) and can be viewed at the following link: http://taxnotes.co.uk/the-venture-capital-schemes/

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[1] ITA 2007 s 257K(1)(a).
[2] ITA 2007 s 257K(5).
[3] ITA 2007 s 257A(3), as introduced by FA 2012 s 38, Schedule 6, paragraph 1 – the SEIS scheme was originally intended to run between 6 April 2012 and 5 April 2017. It is now possible to invest beyond the latter date – FA 2014 s 54 amending ITA 2007 s 257A(3).
[4] ITA 2007 s 257L(1)(b).
[5] ITA 2007 s 257L(4).
[6] ITA 2007 s 257LA – note the difference between the treatment of debt and equity.
[7] SEIS – ITA 2007 s 257AB(5); EIS – ITA 2007 s 158(4); SITR – ITA 2007 s 257JA(4).
[8] See HMRC Manual at VCM10530.
[9] SEIS – TCGA 1992 ss 150E(2)(b), 150E(14), ITA 2007 s 257E; EIS – TCGA 1992 ss 150A(10A), 150A(11), ITA 2007 s 201; SITR – TCGA 1992 ss 255B(2)(b), 255B(8), ITA 2007 s 257N.
[10] EIS – TCGA 1992 Schedule 5B paragraphs 1(1)(c), 1(2); SITR – TCGA 1992 Schedule 8B paragraph 1(1)(b), (c).
[11] The exception to this is the case where upfront relief is lost due to the VCT losing its tax status– in which case all the reliefs go out the window.
[12] ITA 2007 s 274(2).
[13] ITTOIA 2005 s 709(4).
[14] TCGA 1992 s 16(2).
[15] SEIS – TCGA 1992 s 150E(3); EIS – TCGA 1992 s 150A(2A); SITR – TCGA 1992 s 255B(3); VCTs – TCGA 1992 s 151A(1).
[16] EIS – TCGA Schedule 5B, paragraphs 2-4; SITR – TCGA 1992 Schedule 8B, paragraphs 4-6.
[17] TCGA 1992 Schedule 5BB, paragraph 5 – note that the list of chargeable events upon which the original gain is triggered, does not list a sale of the SEIS shares. The only way for the gain to resurface is if SEIS relief is withdrawn or reduced – which would include a sale before the three year holding period is over. Contrast the position with EIS/SITR where the gain will always be triggered on a sale

(interspouse transfers are an exception) – EIS – TCGA 1992 Schedule 5B, paragraphs 3(1)(a), 3(1)(b); SEIS – TCGA 1992 Schedule 8B, paragraphs 6(1)(a), 6(1)(b).

[18] TCGA 1992 Schedule 5BB, paragraphs 1(5), 1(5A).

[19] ITA 2007 s 131.

[20] ITA 2007 s 131(2)(a).

[21] ITA 2007 s 131(2)(b).

[22] ITA 2007 ss 131(2)(b), 134(a)(i), 134(4)(b). By the phrase trading company we include a holding company of a trading group – ITA 2007 s 137(1)(b).

[23] ITA 2007 s 131(1)(a).

[24] IHTA 1984 s 105(1)(cc).