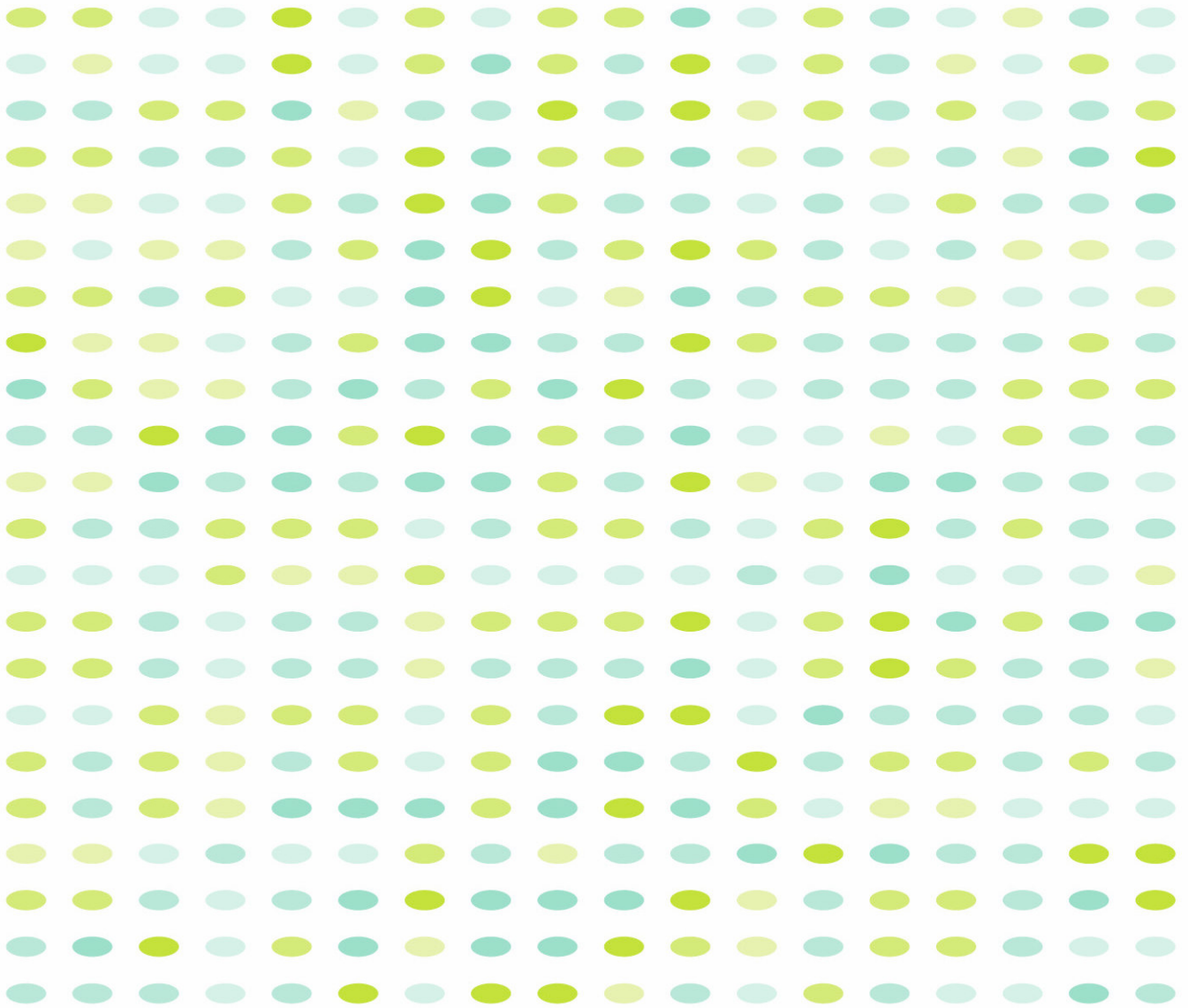


The SWAIN guide to taxation issues and EIS



In conjunction with:

The SWAIN guide to taxation issues and EIS

The South West Angel and Investor Network (SWAIN) connects private investors or “Business Angels” with companies looking for investments.

SWAIN specialises in helping small and medium sized companies to find equity finance, and assists private investors in the South West to search for investment opportunities in businesses with growth potential.

The following guide has been produced to help you understand the taxation issues in connection with buying a business or making an investment into one. It is aimed at investment through a corporate vehicle although investment through a traditional partnership, a limited liability partnership or as a sole trader may also be appropriate.

Taxation issues in context

Taxation is a fact of business life. However, all taxation consequences are not the same and investors should obtain good tax advice to make sure that they get the best structure and tax arrangements that they can for the given circumstances. Whilst it is wrong to let tax considerations drive a commercial deal, the investor should be made aware of the possible tax upsides and downsides as part of making the decision whether or not to invest.

For investors looking to invest in a small or medium sized company the investor needs to consider:

- The taxation issues of buying a business in its entirety, and
- The taxation issues of making an investment into an existing business carried on by a limited company. This includes consideration of the Enterprise Investment Scheme (EIS).

Whilst this guide will consider these issues under separate headings, in reality there is considerable overlap between these two positions and many of the issues will be common to both.

Getting good tax advice

It is important that tax issues are considered at an early stage in the transaction. Whilst some of the tax issues are matters of detail that can be sorted out as part of drafting the documentation, others are potentially fundamental to the whole deal taking place.

This is particularly the case where the investor wants the transaction structured in a particular way to obtain a tax advantage, whereas the existing business owner wants a different transaction structure to benefit his own tax arrangements. Such issues can be fairly easy to straighten out in the early stages of a deal, but become more problematic if Heads of Terms have been agreed.

It is important that the advisers that are chosen have appropriate experience of providing tax advice to entrepreneurs and of negotiating practical and achievable deals.

Buying a business in its entirety

The taxation issues in connection with acquiring a business fall into two categories:

- Establishing existing tax liabilities and achieving protection against unexpected historic tax liabilities, and
- Maximising tax relief on the business acquisition.

Protection from historic tax liabilities

Where the business has been acquired through a purchase of shares in a limited company, the acquirer inherits all the historic tax liabilities of that company. In such a case, it is normal to undertake tax due diligence, to obtain tax warranties and to request a Tax Deed of Indemnity in respect of potential unknown liabilities.

Such approaches may still be relevant if an investor is acquiring less than a 100% shareholding in a company. However, it will be necessary for the potential investor to take a commercial view on the potential risk and cost implications.

Some tax due diligence is always likely to be beneficial but it can be kept fairly informal. Some general tax warranties are also likely to be appropriate in all cases. The key thing is that the investor appreciates the potential risks at the outset. This needs to include consideration of such things as:

- Employees having been treated as self-employed rather than subject to PAYE,
- Incorrect treatment of sales or purchases for VAT purposes, and
- Under declaration of benefits in kind.

Acquiring a business tax efficiently

This is a huge topic. However, there are some general comments that can be made, in particular about the acquisition of a business by an existing company or by a new company formed for this purpose by a Business Angel(s). Such an acquisition would be an asset purchase.

As far as an asset purchase is concerned, tax relief should be available on some or all of the purchase consideration. The extent to which it is available will depend upon the nature of the business activity and of the assets being purchased. The time period over which tax relief is being obtained will also vary between the different tax status of assets being acquired. Some of the areas to consider will include:

- Intangible assets including goodwill;
- Plant and machinery;
- Industrial buildings (including hotels), and
- Fees and expenses.

VAT may be an issue especially if there are high value assets or if the business being acquired is partially exempt. Depending on whether or not the purchase is deemed to be a Transfer of a Going Concern (TOGC) then there may also be implications for the Stamp Duty Land Tax (SDLT) payable.

The availability of substantial tax reliefs on the acquisition of the business may result in tax losses being available in the early years, even if the business is profitable from the outset as far as the accounts are concerned.

These issues may also be relevant if a Business Angel is investing in an existing company in order to help finance a new business acquisition.

Making an investment into an existing business

The Business Angel needs to get the structure right from the outset and there may be implications for the investors' existing financial affairs including will arrangements. The investor needs to consider the most favourable tax arrangements should the investment turn out to be successful, in order that tax on any gain is minimised. However, the investor should also consider what tax reliefs are available should the investment turn out to be unsuccessful.

In particular the investor needs to consider how the investment is to be financed, how the return on the investment is to be achieved i.e. as a capital receipt on eventual sale or by interest/dividends on the investment and whether any special tax breaks are available such as rolling over a capital gain.

Some of the specific points to consider are as follows:

- As long as the investor subscribes for new shares, then subject to some restrictions on qualifying companies, the investor will be able to set off a loss on the investment against other income.
- Business asset taper relief should usually be available on any investment into the shares in a trading company. For a higher rate taxpayer, then after a year, this should reduce the tax rate on any gain to 20% and then to 10% after two years. However there are possible complications and restrictions and it is no longer possible to get a tax ruling on the business asset status of a company.
- The income tax position on investing in a management buy out (MBO) is particularly complex and careful advice should be sought in order to avoid adverse tax consequences. As a result MBOs tend to be very time consuming (and therefore expensive) from a tax perspective.
- If the investment is to be financed by a loan, then it is important to structure the arrangements so that tax relief on the loan interest is obtained. However, this will not be possible if EIS relief is to be claimed.
- If the investor has shareholdings in other companies, then care will be required to ensure that companies do not become associated which would have adverse tax consequences for corporation tax purposes.
- Subject to certain qualifying criteria, business property relief (BPR) should be available to exempt the shareholding from inheritance tax after two years. Depending on the previous business activities of the investor, then the shares may even qualify as replacement property, such that the two year waiting period is not required. Care is required over the drafting of shareholder agreements to avoid the BPR being denied. This can happen if the shareholder agreement amounts to a binding contract for sale on the death of the investor. For this reason it is common to use put and call option arrangements in the shareholder's agreement.
- Full EIS relief or merely capital gains tax (CGT) deferral relief under EIS may be available and this is considered further below.
- Enterprise Management Incentives (EMI) may be a useful way of both remunerating and incentivising the management team. An EMI is a very tax favoured option arrangement.

Enterprise Investment Scheme (EIS)

EIS is both a very generous tax relief scheme and a very complex one. The scheme is a successor to the old Business Expansion Scheme and Reinvestment Relief. The complications derive from anti-avoidance legislation introduced to counteract abuses of those former schemes. Unfortunately EIS planning is often done on the cheap at the outset with adverse consequences later on. The investor needs to pay for good advice prior to any involvement with the company in order to make sure that qualifying conditions are not breached.

It is important to appreciate at the outset that there are two types of EIS relief:

1. The full EIS relief which includes exemption from CGT on any gain, the potential for CGT deferral relief and a 20% income tax credit. The maximum up front tax relief under this relief is 60%. In order to qualify for this relief, the maximum ownership of the shares and loan stock by the new investor is limited to 30%. Understandably there are also a large number of further restrictions that can apply.
2. The more limited form of EIS relief is referred to as CGT deferral relief. Under this relief, there is no restriction as to the percentage ownership of the shares and loan stock but there are still a number of complex restrictions to consider. The maximum tax benefit is 40% of the investment although the tax relief percentage is typically lower because of the likelihood of taper relief being available on the original gain.

Further details on EIS are available from the online help on the H M Revenue & Customs (HMRC) website at www.hmrc.gov.uk. A similar scheme applies to corporate investors and is known as the Corporate Venturing Scheme (CVS).

EIS Qualifying Status

In order to benefit from EIS relief, the company must be a qualifying company. Similar qualification criteria apply to the EMI and CVS schemes. A number of businesses that are considered to be asset rich and therefore less risky, are excluded from qualifying. The most common are farming, property development, hiring of assets and hotels but there are also a number of other restricted trades that do not qualify for EIS. Non qualifying activities can be carried on by the company as long as those activities are not significant. In this context significant means more than 20% of the activities.

Advice should be sought from expert tax advisors as to whether or not the trade qualifies. To assist the investor (and the company concerned) a clearance procedure is available from HMRC. Clearance should be sought but it will only be valid as long as all matters are fully disclosed in the clearance application. For instance it is important to disclose future expansion plans especially if these could include non-qualifying activities or overseas expansion or even the acquisition of subsidiary companies.

The clearance applications are dealt with by the specialist Small Company Enterprise Centres of HMRC. Clearance can only be obtained to say that the company's trade qualifies for the EIS relief on the basis of the facts disclosed to HMRC. HMRC will not confirm that the specific investment will qualify for the relief.

Some Dos and Don'ts on Share Issues

As already explained, EIS is a very pedantic relief. Some points to watch out for on share issues are:

- The shares must be subscribed for in cash. The investor must not purchase the shares from an existing shareholder. The shares must not be issued in exchange for services or assets transferred to the company. If this is the arrangement then the company must acquire the service or asset as a separate transaction on arms length terms.
- The shares must be fully paid. It is important that formal company secretarial procedures are complied with and that monies are properly paid as set out in the subscription letter.
- The shares must be ordinary shares. The investor can not receive shares on terms that are preferential to the other shareholders.

Where the full EIS relief is being claimed then it is important that the existing connection tests concerning

previous employment are fully complied with. It is also important that the percentage control tests are strictly complied with. In this context it is important to consider all the tests of control and to refer to any arrangements set out in a shareholders' agreement.

Procedure for Claiming EIS Relief

After the investment is made, a form EIS1 is submitted by the company to HMRC to claim the EIS relief. This can be a claim either for the full relief or for the CGT deferral relief.

If HMRC are satisfied that the relief qualifies, then the Inspector will issue form EIS2 which will enable the company to issue the EIS3 certificate to the investor. This will show the period for which restrictions apply to the shares in the company in order to avoid any claw back of the EIS relief. These restrictions relate to the company's trading activities and prevent diversification into areas that could mean that it ceases to be qualifying for EIS purposes. Restrictions also apply to the percentage shareholding and financial arrangements between the investor and the company. The period for which the restrictions apply is usually three years from the date of the share issue.

The income tax relief is obtained through the self-assessment income tax system and will reduce the tax that will otherwise be payable on the due date. The CGT deferral element is available in respect of gains made in the three years prior to the investment in the shares or in the following 12 months. Therefore, where the gain has been made in a previous tax year, a tax repayment could be obtained as soon as the EIS3 certificate is issued by the company to the investor.

There are both upsides and downsides in terms of claiming EIS relief in respect of an investment. In the past venture capitalists have been known to resist investing in companies where EIS relief applies. This is because the rules may interfere with commercial decisions that would otherwise be made. The complications and restrictions should not be underestimated, but against this, the benefit of the tax relief substantially reduces the after tax cost of the investment and therefore reduces the cost of capital on the investment to the potential benefit of both the investor and investee.

Conclusion

Early taxation advice is vital in structuring a successful investment. The advice needs to be bespoke to the individual to reflect the specific circumstances in each case.

If you are thinking of investing in a private company or looking to acquire a business, then you should take early advice from a specialist firm of tax advisors. Details of such firms and associated members of SWAIN can be found at

www.swain.org.uk

Or if you would like to discuss any of the issues raised in this guidance note, please contact any of the following at Winter Rule, Chartered Accountants and Business Advisors, which have prepared this guide:

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