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THE SEED ENTERPRISE INVESTMENT SCHEME

A new form of the Enterprise Investment Scheme (EIS) is to be introduced for investments in certain smaller companies after 5 April 2012.

For a number of years, the EIS has provided tax incentives for investors in trading companies, and the new Seed scheme (SEIS) offers similar but more generous incentives for investment in smaller, newly started companies.

In order to qualify for the SEIS, a company must be carrying on a "qualifying" trade, or preparing to do so, and it must have assets of no more than £200,000 before it issues the SEIS shares, and no more than 25 employees. It must have been incorporated no more than two years before the SEIS shares are issued.

The definition of a "qualifying" trade is the same as for the ordinary EIS, and broadly speaking, it excludes asset-backed trades such as hotels, farming, care homes, and also trades within the financial sector.

The company is allowed to raise up to £150,000 from issuing SEIS shares. This is an absolute limit, not an annual one.

Individuals who invest in SEIS shares must not end up with more than 30% of the company's share capital, and each individual is limited to a maximum investment of £100,000. The investor can be a director of the company, but curiously, employees and their associates cannot invest.

The scheme is to run from April 2012 to April 2017, with the possibility that it may be continued after that date. The SEIS shares must be held for a minimum of three years, during which time the company must continue to carry on its "qualifying" trade, in order for the generous tax reliefs not to be clawed back from the SEIS investors.

The tax reliefs available for SEIS investors are:

◊ Income tax relief of 50% of the sum invested
◊ Exemption from capital gains tax on the SEIS shares
◊ For the first year of the scheme (ending on 5 April 2013), exemption from capital gains tax on any other capital gains made in 2012/13, up to the amount invested in the SEIS
◊ For future years, the ability to defer paying capital gains tax on other gains in the year, up to the amount invested in SEIS shares, until the SEIS shares are sold

This means that for the first year of the scheme, tax relief of 78% will be available to some SEIS investors. If an individual has made a capital gain of, say, £50,000 in 2012/13, and he invests £50,000 in SEIS shares, he will get an income tax repayment of £25,000 (assuming he has paid that much income tax in the year), and his capital gain, on which he would otherwise have had to pay £14,000 capital gains tax in January 2014, will be exempt from tax. Of his investment of £50,000, £39,000 will be covered by the combined income tax and capital gains tax reliefs, so it will have cost him only £11,000.

Assuming his SEIS shares are still worth at least £11,000 after three years, so that he gets the cost of his investment back, his investment will have cost him nothing. If the SEIS Company has done well, any gain he makes will be free of tax.

The SEIS is designed to apply to smaller start-up companies, and the conditions are quite strict, but given the extremely generous tax incentives for investors, it will be interesting to see how many such companies we see taking advantage of the scheme. Certainly, for someone planning to start up his own small business, the SEIS may be just what is needed to attract investors.

This article by James Bailey first appeared in Tax Insider magazine (www.taxinsider.co.uk)