SPECIAL REPORT
ENTERPRISE INVESTMENT SCHEMES

SPECIAL REPORT

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EIS in financial planning

Are Enterprise Investment Schemes worth the risk? Fiona Bond talks to paraplanners about why, when and how they use EIS with clients

Nearly three decades on from its launch, the Enterprise Investment Scheme (EIS) continues to garner significant interest from investors. While scheme rules have evolved over the years, its core purpose to help early-stage, high-risk companies raise finance from investors in return for generous tax reliefs has remained unchanged.

To date, 31,365 companies have benefitted from the scheme, with £22 billion invested. With the potential for investment in high growth companies whilst also receiving tax reliefs, the financial planning case for EIS can be compelling.

Sian Davies Cole, director of Plan Works, believes that for a select number of sophisticated investors, EIS offers a very effective tax planning tool. One of the key tax advantages is Loss Relief. This allows losses accrued in the investment portfolio where an individual company may fail, to be offset against the client's marginal rate of income tax or capital gains tax exemption, while also receiving the upfront tax reliefs. These reliefs currently enable investors to claim up to 30% income tax relief, providing they hold the shares for a minimum three-year period and 100% inheritance tax relief after only two years. In addition, any gains made on the shares are Capital Gains Tax-free and investors can also use an EIS to defer a CGT charge. For Davies Cole, this latter incentive can be particularly useful for clients.

She explains: "For clients who have incurred a capital gains tax, say for example on the sale of a second home, EIS offers the only option to offset some of those gains and providing the investor continues to invest in EIS, they can continue to defer. This can be a big distinguisher between choosing an EIS or VCT for a client."

But while the host of tax incentives can be undoubtedly tempting, there is a significant risk/reward trade off. Small, unquoted companies lack the track record and stability of their larger counterparts and as the saying goes, lemons ripen faster than plums.

According to the Enterprise Investment Scheme Association, typically, four companies in 10 will fail before any returns are realised which can make the first couple of years invested in an EIS portfolio unnerving. This means EIS are typically the reserve of high-earning, high net worth investors with substantial assets who are comfortable with a high level of risk.

"Being able to see the tangible impact of your investment and understand where the money is going can be really positive and helpful for EIS clients"

Sian Davies Cole, Plan Works

Matthew Harrison, paraplanning manager, the RU Group, says: "From a product point of view, EIS can be very beneficial if used correctly. For example, I worked with a client who had a high level of income, had recently sold land which had triggered a CGT charge and had an IHT problem. For this client, an EIS was a natural next step and it worked really well as part of their wider portfolio.

"However, you need to have utilised other tax efficient investment vehicles first and be able to outweigh the tax reliefs on offer against a high level of risk and market volatility."

Davies Cole observes: "It's paramount that the client fits the profile and has a very decent risk profile. Paraplanners need to ensure that the client has complete capacity for loss, both emotionally and financially, and would be able to continue to maintain their lifestyle in the event of a loss."

According to Reece Edwards at Hampshire Hill, it's crucial paraplanners fully understand the mechanisms within an EIS before exploring the product with a client.

"Firstly, I believe they must have considered and be able to document other investment propositions first. As these products are high risk, full discussions between the paraplanner and the adviser around why other vehicles have not been used could be more important than documenting why as EIS has been used."

Edwards adds: "Generally, we would only suggest an EIS with a minimum of 10 investee companies. To protect ourselves and the client, we would only recommend an EIS through a provider that is an expert in this field."

Understanding the structure

However, understanding the risk and structure of individual schemes can be challenging and requires a high level of research and due diligence.

For Harrison, this can be a considerable task for paraplanners. "There is huge complexity surrounding the companies an EIS invests in. An

investor could end up with a number of underlying investments which all pay out at different times and that can make it difficult for investors to keep track," he explains. "Paraplanners need to give very careful consideration to which provider to go for and really delve into the individual companies included within the EIS."

Research tools such as MICAP or Martin Churchill reports, while costly, can offer a helpful starting base, paraplanners say.

Davies Cole says paraplanners "cannot and should not" research the entire market by themselves. She says: "There are great resources available, which include a wealth of data, and these can be extremely helpful in whittling down a shortlist of prospective schemes."

For some clients, the opportunity to invest in innovative companies with the potential to transform future industry can be a powerful incentive beyond the tax reliefs and those companies that produce relatable products tend to find favour. "Being able to actually see the tangible impact of your investment and understand where the money is going can be really positive and helpful for EIS clients," says Davies Cole.

And with six million small businesses operating in the UK in 2020, 2.5 million more than in 2000, the need for early-stage investment is only set to grow. Edwards concludes: "If the client understands the high-risk nature of an EIS and realises why the vehicle is being used, I think it is worth it. As always though, it has to be right for the client."

"I worked with a client who had a high level of income, had recently sold land which had triggered a CGT charge and had an IHT problem. For this client, an EIS was a natural next step and it worked really well as part of their wider portfolio"

Matthew Harrison, RU Group

Unpacking EIS

Jessica Franks, Head of Tax, Octopus Investments, tells Rob Kingsbury about the motivation for investors to invest in Enterprise Investment Schemes, as high risk investments and why, almost counter-intuitively, now may be a favourable time to invest

Talking to Jessica Franks, Head of Tax at Octopus Investments, about the nature and scope of Enterprise Investment Scheme (EIS) investing, it becomes clear that EIS is only going to be suitable for specific investors. But the potential for an EIS portfolio, combined with the range of tax reliefs available, can make EIS a powerful addition to a diversified portfolio.

This may be especially so in the current environment, as not only can clients benefit from the range of tax reliefs, but also investments made into early stage, agile companies could be an attractive option as we begin to come out of the Covid crisis.

Starting with the client profile of a typical EIS investor, Jessica says EIS tend to be invested in by wealthy, sophisticated investors who are prepared to invest in an illiquid investment that is high risk, and taking a long-term position. "Investors often are excited by the opportunity to back a portfolio of 10-15 companies which could become the household names in the future. Investors get to feel close to the companies within their portfolio, because it's a relatively small number of investments," Jessica says.

As these are early stage investments, some will fail. The government has allowed for a number of valuable tax reliefs as an incentive for taking on the higher risk associated with EIS, which include: 30% upfront income tax relief, tax-free capital gains, loss relief, capital gains tax deferral, and inheritance tax relief.

Typical investor scenarios include clients who have realised a gain, such as the sale of a second property or a stocks and shares portfolio. Where an investor is facing a large CGT bill, they may want to look at ways to defer that gain while also diversifying their portfolio. When investing part or all of a capital gain in EIS shares, the gain is deferred until the sale of those EIS shares, which can mean that investors have the potential to use their CGT allowance over several tax years as exits from companies are made within their EIS portfolio.

Another scenario might be where an entrepreneur has sold a business and benefited from Business Asset Disposal Relief (formerly Entrepreneurs Relief) for part of their gain, but is interested in the possibility of deferring some of that gain while also backing other businesses.

Jessica sees 2021 as "a particularly interesting time" for EIS. She says: "The level of upheaval we've seen in the economy and for businesses can better suit smaller companies. They can be more agile and adapt to a new environment faster than larger companies. Also, this kind of environment is one where entrepreneurs can spot opportunities to create businesses, especially the kind of companies that our Octopus Ventures EIS Service will look at, which tend to be technology enabled."

Jessica feels it's these kinds of opportunities that sophisticated investors both understand and are willing to invest in, especially because the various tax reliefs act as a cushion against some of the risks, bearing in mind they can never entirely mitigate them. "People can be naturally cautious in times of uncertainty, but it is these smaller and nimbler businesses which have the opportunity to prosper and grow as we come out of the pandemic. These opportunities should interest sophisticated investors at the moment.

"The Patient Capital Review published by the government in 2017, analysed the entrepreneurial framework coming out of Brexit, to ascertain how well positioned the UK was to be a successful nation once it had exited the EU. It found that the UK is a favourable arena for entrepreneurial start-ups and growth companies and part of the rationale for that was the availability of capital through EIS. There is a tangible benefit from EIS having been tried and tested over the past 25 years, which means the scheme is now well established as a means for investing and supporting smaller companies looking to grow – all of which is good for the UK economy."

Jessica stresses, however, that an EIS portfolio is a long-term investment. "While you need to hold EIS for a minimum of three years to retain the tax relief received for entering the investment, they shouldn't be viewed as a three-year investment. You will be investing directly into the shares of small companies that you will back while they look to scale, typically not a short journey. We use five to 10 years as an indicative investment period."

More than investment

Given the nature of its transactions, the Octopus Ventures EIS Service has to be about more than the investment, Jessica says. "The Octopus Ventures team are known in the entrepreneurial community for their high level of experience and specialist skill set. They are well resourced to provide a high level of ongoing support for companies as they grow."

This support, she explains, can include coaching for the management team, and linking management with an external network of experienced entrepreneurs who regularly share their advice and expertise, complementing the knowledge from the investment team. The team also has a network of partners in other countries, who can help UK-based businesses scale into overseas markets. The Octopus team has been an early investor in high profile names, such as Zoopla Property Group, Secret Escapes, Tails.com and graze. "And we are often approached by successful entrepreneurs we have backed previously to invest in their next business," Jessica adds.

The EIS portfolio structure

"EIS is designed to help mitigate risk when structured into a portfolio such as that offered by the Octopus Ventures EIS Service," Jessica explains. "We allocate investors a portfolio of, typically, between 10 to 15 companies. They can claim up front income tax relief of 30% of the amount they have invested into each company. Relief is available in the year the investment is made into the underlying company not the portfolio, but can also be carried back to the proceeding tax year. With these kinds of investments, which have to be carefully researched and selected, it can be a while before the money is invested into the businesses, so being able to carry back can be a useful tool."

A relief that can be undervalued, Jessica says, is Loss Relief. "This is available on a company by company basis. So should one or more company fail, Loss Relief can be claimed on them separately and irrespective of the overall performance of the portfolio. The Loss Relief can be claimed against income tax and also against capital gains tax. So investors will have received 30% upfront income tax relief and can claim 45% on a loss, which can be a cushion against the investment risk.

"This is a unique situation when it comes to investments that come with tax reliefs. With EIS, you're getting relief on the upside and you can also get it on the downside. It's important to never invest purely for tax relief purposes, but as the nature of EIS investing is high risk, which means investors should be prepared for at least some of their portfolio to fail, the reliefs can help mitigate the impact of the losses."

Resources for paraplanners

Octopus has a number of useful tools for advice firms to use with clients and to help with researching EIS. These include: a client facing EIS guide[1]; an EIS illustrator which paraplanners can use to show not just fees and charges but also what the outcome might look like for the client, for example in terms of the tax reliefs; a soon-to-be-launched EIS calculator, which can help paraplanners show the benefits of investing in an EIS for clients; and client case studies to show where EIS may work for particular types of clients.

"We run regular webinars on EIS, not just explaining the structure of EIS investments but also introducing our investment managers. And, of course, we have our business development team, who are able to talk though specific client scenarios," Jessica adds.

"We also have an interactive board game, using a fictitious company with a number of staff members all with different tax needs, which is useful for thinking through different scenarios and solutions.

"We are never product led, we are about the advice firm's clients and what they are trying to achieve and what the right solution is for them. The specialist and high risk nature of EIS mean that the investments are not going to be right for many people, but where they are, we can talk it through with the paraplanner, or help them with their research, to ensure it is a good match for the client's needs."

[1] https://media.octopusinvestments.com/m/62d9e4b604728e07/original/Guide-to-Enterprise-Investment-Schemes.pdf

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Estate Planning

EIS investments typically qualify as BPR investments. This can be a useful tool for entrepreneurs who have sold their business, and were eligible for Business Property Relief (BPR) for inheritance tax (IHT) purposes. Investing cash from the business sale into an EIS would be IHT efficient as it immediately qualifies for the relief. However, the cash cannot have been invested elsewhere in the meantime and the investments through the EIS have to be held at time of death to benefit from the tax relief. "For this reason it should not be seen as a primary estate planning tool but it can be a useful benefit for clients," Jessica says.

Guide to EIS

Jessica Franks, Head of Tax, Octopus Investments provides an overview of the Enterprise Investment Scheme (EIS) to help paraplanners research these tax efficient vehicles and recommend them to the right clients

> *"By investing at the start of a company's journey, investors have an opportunity to share in that potential success. These types of companies are typically innovators finding solutions to everyday problems or creating something that didn't exist before, and investors like being part of that journey"*

One of the best ways to significantly increase personal wealth is to make an early investment into shares of a small business that goes on to achieve extraordinary growth. And the earlier a client invests in such businesses, the more value they can get as a shareholder.

Launched in 1994, the Enterprise Investment Scheme (EIS) makes investing in shares in early-stage businesses even more attractive. That's because investing in an early-stage business that is EIS-qualifying gives investors the opportunity to claim a number of tax reliefs alongside their investment, including upfront income tax relief, tax-free capital gains, and loss relief on each investment, should the company fail. The government offers EIS tax reliefs to encourage investment into early-stage businesses with high growth potential. They do this because smaller businesses that mature into successful, established companies create jobs and stimulate valuable economic growth in the UK. Since EIS was launched, more than 31,000 qualifying early-stage businesses have benefited from £22bn of investment[1]. In 2018-19 alone, £1.8bn was raised by companies that qualify for EIS.

How can clients access EIS?

Generally, there are two main routes:

1. A single-company EIS – the most direct method. An investor selects a specific company that they would like to invest in. They'll need to undertake research that requires time, knowledge and expertise.
2. A specialist manager – investors choose an investment manager who will invest the funds on behalf of multiple investors in a portfolio of several qualifying companies. Having a specialist manager provides certain benefits to investors, such as ongoing oversight of the companies in the portfolio, the potential to influence board-level decisions (if the manager is large enough to have a seat on the investee company's board) and the expertise needed to negotiate an advantageous exit.

Why invest in EIS?

There are many reasons people typically invest in EIS. First and foremost is growth. The types of companies seeking EIS funding are aiming for significant growth. By investing at the start of a company's journey, investors have an opportunity to share in that potential success. These types of companies are typically innovators finding solutions to everyday problems or creating something that didn't exist before, and investors like being part of that journey.

Smaller companies normally follow different investment cycles from other parts of the investment market, and because of that can add an extra layer of diversification to a client's portfolio. EIS investments are long term and have unique benefits and risks. As a result, some investors see them as complementary to their existing investments, such as ISAs, VCTs and pensions. However, it should be remembered that EIS is a high-risk investment that should not be considered a replacement to more mainstream long-term investments such as pensions. One of the other big reasons people invest in EIS is the tax reliefs that help to compensate for the risks involved.

What tax reliefs do EIS offer?

INCOME TAX RELIEF: Investors can claim up to 30% annual income tax relief on EIS investments up £1m.

TAX-FREE GROWTH: When EIS-qualifying shares are sold, any growth in the value from an investment is 100% tax-free.

CAPITAL GAINS DEFERRAL: A gain made on the sale of other assets can be reinvested in EIS-qualifying shares and deferred until the EIS shares are sold.

INHERITANCE TAX RELIEF VIA BUSINESS PROPERTY RELIEF: EIS-qualifying shares can also qualify for Business Property Relief (BPR), meaning they can be left to beneficiaries free from inheritance tax, provided they have been held for at least two years and at the time of death.

LOSS RELIEF: Should the value of EIS-qualifying shares drop to nil or, if the shares are sold for less than the original amount invested net of income tax relief, loss relief is available. It allows an investor to offset a loss made on a company against either capital gains tax or income tax at their marginal rate.

An investor must hold EIS shares for three years in order to keep any income tax relief claimed, although they should expect to hold shares until an

exit opportunity which is typically much longer than three years. Tax treatment will depend on individual circumstances, and tax rules could change in the future. Tax reliefs depend on the portfolio companies maintaining their qualifying status.

Which companies qualify for EIS?

There are several rules about whether a company qualifies to receive EIS funding. Before we get into the detail there are a few basic premises which a company needs to follow. A company has to have a permanent establishment in the UK and carry out what HMRC calls a 'qualifying trade'. Although most trades qualify, there are some that the Treasury believes are not in need of additional financing support, and as a result wouldn't qualify for EIS investment. These include activities like land dealing, running hotels, farming, financial activities and energy generation.

The rules state the maximum size and age of companies that can qualify, as well as limits on how much funding they can receive. The idea is to direct capital to those companies that need it the most:

- Companies can't have gross assets of more than £15m at the time of investment.
- In addition, gross assets can be no more than £16m immediately after investment.
- The company must have fewer than 250 full-time employees when the investment is made.
- Companies need to be less than seven years from the date of their first commercial sale.
- Companies that qualify can receive up to £5m of EIS or other tax-efficient funding in any twelve-month period, with a cap of £12m over its lifetime.

The limits above are more generous for what are called knowledge-intensive companies. These are companies that have a large proportion of highly skilled workers, for example scientific researchers, or that meet certain innovation conditions.

So what kind of investor is EIS for?

The tax reliefs of EIS investments can be very compelling, but remember why the Government offer them. They offer them to incentivise investments into smaller businesses. Yes, these businesses have the potential to grow significantly but they also typically have a higher failure rate and are illiquid. So, what types of clients could suit this kind of investment?

It's often clients who are experienced investors who are looking to further diversify their portfolios. They might have invested in other small companies via Venture Capital Trusts and be looking for something different. They'll typically be high earners who are comfortable taking risk with a certain portion of their investible money.

They've often maxed out their annual pension and ISA allowances. You'll also tend to see investors with more unique planning needs. Investors who have made capital gains from other assets might look to defer them into EIS investments. Common situations could be gains made from selling a second property or rebalancing a share portfolio.

Understanding the risks

The first step with any client is to make sure they understand the risks before making any investment. EIS is a high-risk investment. The value of an EIS investment, and income from it, can fall as well as rise. Investors may not get back the full amount they invest. Tax treatment depends on individual circumstances and may change in the future. Tax reliefs also depend on portfolio companies maintaining their qualifying status. Clients will also need to be comfortable with the idea of holding the shares for at least three years in order to keep any income tax relief they claim. EIS shares may be harder to sell than shares listed on the main market of the London Stock Exchange as clients can typically only access their money if there's an exit opportunity such as a sale or a listing on a public market. This can take up to ten years or more. They should also keep in mind that share price of EIS companies can be volatile.

[1] National statistics published by HMRC 29 May, 2020.
[2] Association of Investment Companies, 30 Sept 2020.

For tax planning case study see overleaf.

Enterprise Investment Scheme case study: Looking for high growth investment opportunities

This tax-planning scenario is designed to help paraplanners and advisers develop appropriate planning strategies for their clients. Paraplanners and advisers should consider, among other things, the value of tax reliefs for their client. You will also need to consider the impact of charges (including initial fee and ongoing fees such as annual management charges) relevant to the products represented and/or any specific product you have chosen.

David, 50, is a director in his firm, and a high earner with a salary of £170,000 a year – on top of which he receives a bonus. This year, the bonus is £120,000. Normally, he invests part of his bonus in long-term investments. Every year he utilises his annual pension allowance, and has previously invested twice in Octopus Titan VCT – the largest Venture Capital Trust in the UK[2]. This year he would like to use part of his bonus to diversify his long-term investments, and is looking for something that feels more exciting with the potential for high growth. He understands that investments with significant growth potential are typically high risk. In addition to targeting significant returns, David is also passionate about helping small businesses succeed. So, he is keen to use this money to help fund some innovative companies, whilst being part of their growth story.

An EIS solution from Octopus

David talks to his financial adviser, who makes an assessment based on David's objectives, risk appetite and attitude towards small company investing, and recommends the Octopus Ventures EIS Service. The adviser explains that this investment will provide David with shares in 10-15 exciting, early-stage businesses, each selected for their potential to grow by ten times over the next five to ten years. David knows Octopus from his previous investments in Titan VCT, and that Octopus has backed, supported and exited some extraordinary rising stars which are now household names (including Zoopla, Graze, Secret Escapes and Tails.com).

His adviser explains that investing in companies aiming for such high growth is high risk, and not all early-stage companies succeed. However, to provide an incentive for the risk involved, there are valuable tax reliefs that David could receive.

David is able to claim 30% tax relief on his investment, which is available to offset against his income tax, such as the tax on his bonus. Where a company in David's portfolio achieves the high growth targeted, it will be free from capital gains tax. His adviser explains that where a company fails, David would be able to claim loss relief against income tax or capital gains – even if his portfolio has increased in value overall. As David is an additional rate taxpayer, he could claim loss relief at his marginal rate of tax of 45%. His adviser explains that this can mean that an EIS portfolio is a very attractive way to make high-risk investments in smaller companies in the pursuit of growth.

David chooses to invest £100,000:

- After Octopus' initial fee and an initial dealing fee have been paid, David will invest £97,030.
- Some of the companies in David's portfolio benefit from strong performance over the next eight years, with two delivering very attractive growth when they are sold. One company never achieves success and simply returns the amount David invested when it is sold, and two fail completely, losing all of David's capital. Overall, David's £100,000 investment in the service returns £271,684 of proceeds when each company is sold.
- He claims 30% income tax relief totalling £29,110 (£5,822 per company).
- David is entitled to claim loss relief in respect of his effective loss on the companies that failed, which is the amount invested into each company (£19,600) less the income tax relief claimed (£5,822). This amounts to £13,778 on each failed company.
- David chooses to offset the effective losses of £27,556 against his income in the tax year each loss occurred as an additional rate tax-payer, he obtains relief at 45% totalling £12,400.

OVERVIEW OF DAVID'S OCTOPUS VENTURES EIS INVESTMENT

	Total	Performance of a portfolio of five EIS companies				
		10x	3x	1x	0x (loses all value)	0x (loses all value)
Amount invested	£100,000					
Octopus initial fee (2%)	(£2,000)					
Dealing fee (1%)	(£970)	(£194)	(£194)	(£194)	(£194)	(£194)
Amount invested in EIS companies	**£97,030**	**£19,406**	**£19,406**	**£19,406**	**£19,406**	**£19,406**
Proceeds from sales	£271,684	£194,060	£58,218	£19,406	–	–
AMC (2%+ VAT) accrued for 8 years	(£21,561)	(£14,739)	(£6,822)	–	–	–
Performance fee[1] (20%+ VAT)	(£51,232)	(£41,917)	(£9,315)	–	–	–
Dealing fee (1%)	(£2,717)	(£1,941)	(£582)	(£194)	–	–
Gain or (loss) on each EIS company		**£115,863**	**£21,899**	**(£388)**	**(£19,600)**	**(£19,600)**
Gain or (loss) on investment	**£96,174**					
		EIS tax reliefs on David's portfolio				
		All growth of the companies in David's portfolio is free from capital gains tax. Had they not been EIS-qualifying he would have owed a total of £42,111 at a rate of 20%.				
Income tax relief (30%)	£29,110	£5,822	£5,822	£5,822	£5,822	£5,822
Loss relief against income tax (45%)	£12,400	–	–	–	£6,200	£6,200
Total tax reliefs	**£41,510**	**£5,822**	**£5,822**	**£5,822**	**£12,022**	**£12,022**

[1] Performance fee is calculated based on the difference between the proceeds from sales and the amount invested into each company. For full details on the fees and charges, please read the Octopus Ventures EIS Service brochure.

This illustrative example should be used for reference only to show the impact of fees and charges on, and the potential tax treatment of, an investment in the service. There is no target for this service so this illustration is based on our experience of investing in smaller companies and an investment in the service may return more or less than this example. The example shows the impact of charges paid to Octopus but it does not include any charges paid to an adviser.

In an illustrative scenario where of five EIS companies, two return the initial amount invested and three lose all value, loss on investment would amount to £61,576, returning £38,424 of the initial amount invested. Income tax and loss reliefs could total £47,710 (if claimed by an additional rate tax payer).