Explanatory Note

Clause 25, Schedule 5: Enterprise Investment Scheme

Summary

1. The amendments make a number of changes to Schedule 5 mainly of a technical nature to: ensure the Enterprise Investment Scheme (EIS) rules work as intended; align with the underlying EU rules; and interact with the underlying EIS rules. The amendments also make provision to allow follow on funding in older companies that received their first risk finance investment after the age limit because the investment was needed to support substantially new activities.

Details of the amendments to Schedule 5

2. All statutory references are to the Income Tax Act (ITA) 2007.

3. Amendments 31, 32 and 33 insert new sections 173A(2)(aa), 173AA(2)(aa) and 173AB(5)(aa). The text of paragraph (aa) is identical for all three sections. It ensures that any money used for the qualifying business activities of a subsidiary of the company, where that money had been raised by risk finance investments in the subsidiary's previous parent company, will count towards the annual and lifetime funding limits of the subsidiary's current parent company.

4. Amendments 34 to 42 amend the rules in new section 175A that allow a company to be eligible to receive a first risk finance investment even though the company breaches the permitted age limits. Broadly, the amount of risk finance investments in the company must be at least 50% of the company's annual turnover, averaged over the previous five years (the 50% turnover test). The amendments make three changes to the rules.

5. Amendments 34, 35, 36 and 39 align the new rules more closely with the EU Risk Finance Guidelines by amending condition B in section 175A(4) and making consequential provisions. Amendment 36 inserts new paragraph (b) in section 175A(4) which adds a further requirement that a company must meet to be eligible for an initial risk finance investment under the EIS where the company exceeds the permitted maximum age limit of 7 years (or 10 years for a knowledge-intensive company).

6. As well as raising initial risk finance investments of more than 50% of its average annual turnover, the company must use the money raised for the purpose of entering a new product or geographical market. The amendments ensure the investments are used only for activities

that effectively constitute a new business activity, where it may be difficult to raise investment from the market. The amendments do not define in detail what is meant by a new product or geographical market because that will depend on the specific circumstances of each company.

7. Amendment 37 introduces new condition C by inserting new section 175A(4A). New condition C allows a company that has previously met condition B, by way of receiving risk finance investments under the EIS or from a Venture Capital Trust, to raise follow on funding. The money must be used for the same activity or activities for which the money raised under condition B was used, that is to continue to support activities for entering a new product or geographical market. It cannot use the money for a new project or for its other business activities. However if the money raised under condition B was used for, say, two separate activities, the new money raised under condition C does not have to be used for both those activities. For example if one of the activities had already failed, any subsequent money raised could be used for the activity that has continued.

8. Amendments 38, 40, 41 and 42 amend the rules for determining what turnovers must be included when computing the annual turnover of a company to determine if the 50% turnover test in condition B is met, and make consequential provisions.

9. Amendment 38 substitutes a revised version of new section 175A(6), which defines "the average turnover amount" for the purposes of condition B in section 175A(4).

10. Amendment 40 deletes the definition in section 175A(7) of "the total group turnover" which was used in the previous version of subsection (6), now substituted by amendment 8. Amendment 40 defines a new term introduced by revised subsection (6), "the total relevant turnover amount", which is used to determine the average turnover amount of a company under subsection (4). It also defines a "transferred trade" which is introduced by the definition of "total relevant turnover amount".

11. The "total relevant turnover amount" includes the turnovers over the previous five years, as defined by revised section 175A(7), of the issuing company and:

    - where the issuing company is not a parent company at the date of issue of the shares: any 51% subsidiaries it acquires after the shares are issued for which the money raised by the issue of the shares is used; and the turnover of a transferred trade for which the money raised is used, to the extent that its turnover over the previous five years has not already been taken into account.

    - where the issuing company is a parent company at the date of issue of the shares: any 51% subsidiaries it holds at the time of the date of issue and any 51% subsidiaries it acquires after the shares are issued for which the money raised by the issue of the shares is used; and the turnover of a transferred trade for which the money raised is used, to the extent that its turnover over the previous five years has not already been taken into account.

12. The purpose of the amendments is to ensure that, where a company depends on meeting condition B in section 175A(4), all the relevant turnovers of subsidiaries and trades that have

been acquired both before and after the shares were issued are taken into account. However the turnovers of subsidiaries and trades acquired after the shares were issued are included only if the subsidiary or trade uses any of the money raised by the share issue.

13. Amendment 42 defines the turnover of a trade carried on by a person other than a company by reference to the definition of turnover under the Companies Act 2006. Where only part of a trade is transferred, the turnover should be apportioned as is just and reasonable.

14. Amendment 43 introduces new paragraphs 15A and 15B to Schedule 5.

15. Paragraph 15A inserts new section 241(1)(za). Section 241 requires a company to notify HM Revenue & Customs (HMRC) of breaches or potential breaches to the continuing conditions for eligibility to EIS investments. Paragraph (za) requires a company to notify HMRC of breaches to the funding limits and age limits in sections 173A, 173AA, 173AB and 175A.

16. Paragraph 15B inserts new section 247(3A). Section 247 allows shares in a new parent company, that have been exchanged for shares in a company that has raised EIS investments, to remain eligible for EIS relief as though the new parent company were the old company, provided certain conditions are met. Subsection (3A) clarifies that where such an exchange of shares occurs, certain rules for determining if the funding limit and age limit of the new parent company are breached after the shares are issued are not to be applied simply because the parent company has acquired the old company as its subsidiary.

17. Amendment 44 inserts a new subsection in section 251A (Powers to amend Chapters 2 to 4 by Treasury regulations). The new provision allows the rules to be changed retrospectively provided the changes are wholly relieving.

18. Amendment 45 makes a minor consequential amendment.

Background note

19. The EIS encourages investment in small, higher risk, trading companies by offering tax incentives to individual investors in qualifying companies.

20. Schedule 5 to the Finance Bill includes a number of amendments to the EIS rules aimed at ensuring compliance with Articles 107 and 108 of the Treaty on the Functioning of the European Union. State aid approval for the Enterprise Investment Scheme and the Venture Capital Trusts was received on 12 October 2015.

21. The amendments make a number of changes to Schedule 5 to correct technical flaws, align more closely with the underlying EU rules for risk finance investments and in response to comments on the Finance Bill provisions made by venture capital industry specialists.

22. The changes generally reflect changes also being made to Schedule 6 (Venture Capital Trusts).