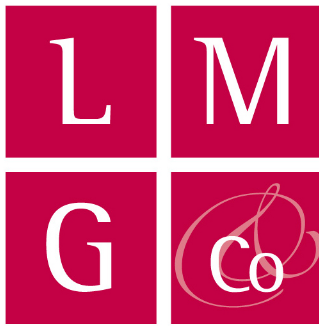

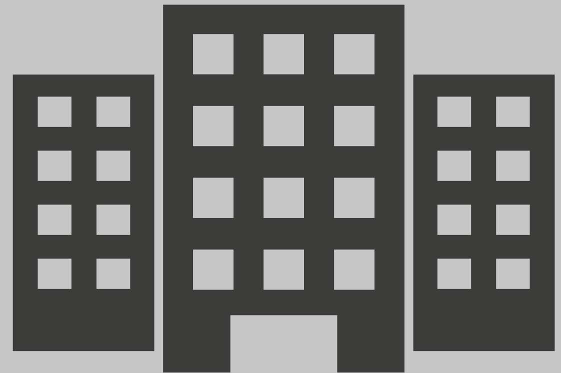

Investing in small companies

A beginner's guide to investing in small entities and the tax reliefs available for doing so.

Starting a business is rarely glamourous. Many of the globe-straddling behemoths of the business world had low-key beginnings. Both Apple and Hewlett-Packard were famously started in their founders' garages, while the mighty Samsung began life as a grocery store in Korea in 1938.

Most of these household names needed investment in order to grow into the brands we know today.

Small businesses are an essential component of the economy and accounted for 99.3% of all private sector businesses in 2016.

The government wants to encourage investment in this vital part of the economy and offers tax relief on certain kinds of investment.

While they are higher-risk investments, small companies also have potential benefits:

- small companies can have greater growth potential than larger, more established companies
- many investors look to small companies as a source of growing dividends
- small companies have a higher rate of mergers and acquisitions, which could mean a large and quick rise in the value of investments.

So what schemes and tax treatments are available to small company investors?

Enterprise investment scheme

The enterprise investment scheme (EIS) is designed to help higher-risk companies attract investment. It works by offering tax reliefs to investors who buy new shares from qualifying companies.

However, there are conditions attached to the tax relief.

The company

To qualify for the EIS, a company must be unquoted at the time the shares are issued. This means it is not listed on any recognised stock exchange.

AIM and the PLUS Markets (but not PLUS-listed) are not considered a recognised stock exchange for the EIS.

The company must also:

- not be controlled by another company
- not have gross assets over £15 million
- have fewer than 250 full-time employees.

The company can have subsidiaries but they must all be qualifying subsidiaries. For example, it should own more than half of the ordinary share capital and not be controlled by another company by other means.

The investor

The shares purchased must be full-risk ordinary shares and purchased in full. Those acquired with a loan will not qualify for relief.

To access the available tax relief, the investor must not be connected to the company in question. 'Connected' here is defined as controlling the company or holding more than 30% of the share capital or voting rights.

An investor who is a partner, director or employee of the company is also considered to be connected.

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Tax relief

There are 4 tax reliefs available for qualifying shares from qualifying companies:

Income tax

Income tax relief at 30% of the cost of the shares is available for the tax year the investment occurred.

This relief can be claimed up to a maximum of £1,000,000 in investment, which would give a maximum reduction of £300,000.

The shares must be held for at least 3 years or the relief will be withdrawn.

Capital gains tax

For shares that have received income tax relief, there will be no capital gains tax (CGT) due if those shares are disposed of after 3 years.

Loss relief

If the investor goes on to dispose of their shares at a loss, they can set the loss against their general income for that year instead of their gains.

Capital gains tax deferral relief

Individuals and trustees of certain kinds of trusts can defer a gain made on any asset into the purchase of EIS shares within a qualifying period. The gain is deferred until the date that the EIS shares are disposed of.

Any relief is claimed through self-assessment and can only be done once the company in question has sent the investor form EIS3.

Relief is withdrawn if, during the 3 years following the purchase of the shares, the investor becomes connected or the company no longer qualifies.

Talk to us about utilising EIS today.

Seed enterprise investment scheme

The seed enterprise investment scheme (SEIS) is similar in nature to the EIS but it focuses on small, early stage companies.

Young companies often struggle to raise finance as they are seen as a risky proposition so SEIS looks to reward investors with a higher rate of relief. It applies to shares issued on or after 6 April 2012.

Income tax

The relief available through SEIS is 50% of the cost of the shares and there is a maximum annual investment of £100,000. A claim can be made up to 5 years after the investment was made.

Like the EIS, the purchased shares must be held for a minimum of 3 years or the relief will be withdrawn.

Capital gains tax reinvestment

This relief was originally available only to gains made in the 2012/13 tax year, but was then extended to 2013/14.

Assets sold and reinvested (all or in part) in shares that qualify for SEIS in these years are exempt from CGT at the rate of 100% in 2012/13 and 50% in 2013/14.

For claims relating to 2012/13, the annual investment limit of £100,000 applies. For 2013/14, this limit is £50,000.

The last date that a claim can be made for 2012/13 is 31 January 2019. The final date for claiming for 2013/14 is 31 January 2020.

Disposal relief

If the investor has received income tax relief on the purchase cost of their shares and sells them after the minimum 3-year period, there will be no CGT liability on disposal profits.

This relief is only available on the basis that income tax relief has been claimed.

We can give more detail about the SEIS.

Venture capital trusts

Like the EIS and SEIS, venture capital trusts (VCT) are designed to encourage investors to put their money into higher risk, unquoted companies.

VCTs, however, work in a way that is similar to investment trusts in that they are handled by fund managers and are usually part of larger investment groups.

Here investors subscribe to shares in a specific VCT, which then invests in qualifying companies and investors are awarded tax relief.

For a company to qualify for VCT investment, it must be listed on a UK-recognised stock exchange and have fewer than 250 full-time employees. Qualifying companies can raise up to £5 million in a 12-month period.

Tax relief

There are 3 main kinds of tax relief available to VCT investors:

Income tax

Income tax relief of 30% on a maximum investment of £200,000 on newly-issued shares. This relief will be withdrawn if the shares are sold within 5 years.

Dividends

Any dividends paid from VCT investments are not liable for income tax as long as the original investment was not more than £200,000 in any year.

Capital gains tax

Investments in VCTs have no CGT liability no matter how long they are held for.

This means there is no minimum period that the shares need to be owned before they are sold on for this relief to apply.

Losses made from VCT investments cannot be used to reduce your CGT liability from other investments.

For more information on VCTs, contact us today.