EIS and VCT portfolio company mergers and reorganisations

EIS and VCT funded companies can run into trouble if their technology takes longer to develop or additional functionality is required to meet changing market demand.

In neither of these circumstances do the EIS or VCT rules make it easy for talented entrepreneurs to take decisive corporate action to reorganise or merge with other similar companies in order to achieve critical mass or attract the investment that is dependent on them doing so.

Better or more fortunate EIS and/or VCT funded companies with complimentary business plans might simply want to join forces in order to accelerate their growth in rapidly developing markets. Same problem.

EIS rules

Under the EIS rules, investors cannot dispose of their shares within three years of their subscription or, if later, within three years of the company in which they have invested commencing trading ("Three Year Period").

This can be a serious clog on effective corporate action being taken to lubricate the wheels of business in any of these circumstances – and in our view it makes no sense at all that investors must give up their income tax relief so they can execute a corporate action within their company's Three Year Period should this become necessary or desirable.

This restrictive rule means that it isn't possible, if EIS income tax relief is to be preserved, to merge a number of EIS companies into a single group within their investors' Three Year Period (a "Horizontal Merger").

A Horizontal Merger is not possible within a Three Year Period either by one EIS company becoming the parent company of one or more other EIS companies or, alternatively, by a new company being formed to act as the parent company of two or more subsidiary EIS companies if, in either case, any EIS shareholders in an EIS company that would become a subsidiary in the merger subscribed their shares within a Three Year Period that has yet to expire.

There are technical 'locked box' solutions that can overcome this restrictive rule against Horizontal Mergers as EIS companies approach the end of their Three Year period but they are unlikely to work well early on within a Three Year Period if future fund raisings are contemplated as new investors are likely to run shy of complexity.

The development of a franchise or co-operation network could be considered as a prelude to a subsequent roll-up of companies carrying on business in the same market.

In this scenario, at the end of the Three Year Period, a new holding company ("Topco") could then be formed which issues its own consideration shares in exchange for the transfer of shares in each of the operating EIS companies in the network.

Typically, the number of Topco consideration shares would be calculated by multiplying the number of shares in an operating company ("Target") by the ratio of the roll over value of a Target share divided by the adjusted merger value per share of Topco, with each valuation being calculated on the same relative net asset basis.

However, care needs to be taken to ensure that network arrangements fall short of becoming a joint venture that might compromise EIS income tax relief.

There are two areas of risk.

The trades of EIS companies ploughing the same furrow must be different. This is a consequence of the rule that requires that EIS capital may only be employed in the trade of an EIS company and/or its 90% qualifying subsidiaries and this trade must be different to the trades carried on by other EIS companies. HMRC has previously accepted that similar trades being carried on in sufficiently different geographic locations are different trades.

Additionally, an EIS company must not control another company, other than a qualifying subsidiary. Control for this purpose is measured at shareholder level. An EIS company itself must also be independent of another company. Control for this purpose is measured at board level, amongst other tests.
Consequently, contractual joint ventures are easier to establish than joint ventures that utilise special purpose vehicles. However contractual provisions should, in the main, be negative in nature and, in any event, must fall short of a power to direct how an EIS company's affairs are conducted.

Accordingly, where arrangements are contemplated that involve a number of EIS companies carrying on similar businesses with a view to a possible merger in the future it may make sense to work alongside an EIS fund manager.

Acting on behalf of their investors the fund manager could then make investments in these companies through a typical EIS fund structure. This would normally involve the fund manager holding a mandate from the fund investors authorising the fund manager to effect appropriate realisations of the investments made through the EIS fund in these companies once the investors' Three Year Periods have expired.

In this way negative contractual provisions in a network agreement can be used to shape the future growth and development of network companies within similar parameters and a fund manager's discretionary authority can be used to instigate a merger between them in due course.

This combination might provide investors with a high degree of confidence that appropriate and decisive corporate action can be taken as necessary to reorganise or merge EIS companies with other similar companies in order to achieve critical mass or attract future investment that is dependent on this being done.

Drag along provisions might also be included within the articles of association of an EIS company so that minority shareholders can be forced to transfer their shares to facilitate a merger with another EIS company if the majority resolve to do so.

It is possible within a Three Year Period to superimpose a new parent company above a single EIS company (a "Vertical Merger"). Shareholders in a single EIS trading company ("Oldco") are allowed to exchange their old shares for new shares issued by a new parent company ("Newco") without any loss of income tax relief once an EIS 3 compliance certificate has been issued by Oldco to its investors following a minimum trading period of four months.

Such a Vertical Merger may help to attract new investors as their fresh capital, once invested in Newco, can be lent down to Oldco (a "Newco Loan") with that Newco Loan then being secured by the grant of a charge over the assets of Oldco in favour of Newco. In this way, a claim to recover the Newco Loan

will always rank ahead of the unsecured claims of Oldco's trade creditors. New investors are likely to find this investment structure attractive.

VCT rules

The VCT rules are more helpful (though not as regards joint ventures) but are altogether more complex given that VCTs may also hold shares and securities which are non-qualifying legacy investments from a time when VCTs could invest a proportion of their assets in permitted non-qualifying holdings; or in holdings that were originally qualifying holdings but which, because of various changes to the VCT rules, would now be non-permitted non-qualifying holdings if either the same investments were made afresh today in a new 'workout' company or if the old permitted non-qualifying holdings were to be simply novated to such a company.

That said, Horizontal Mergers are possible where a new company is formed to act as the parent company of two or more subsidiary VCT funded companies.

Additionally a Horizontal Merger is possible where one company (B) issues shares to a VCT in exchange for its shares in company (A) and in consequence B either holds more than 50% of A; or where B issues shares to a VCT pursuant to a takeover offer that is initially conditional on B acquiring control of A; or where B issues shares to a VCT whose shareholdings in A are cancelled, redeemed or otherwise extinguished.

However, if the shares issued by B are quoted, that is listed on a recognised stock exchange, which would include TISE but not AIM, then they will only be treated as VCT qualifying holdings for a period of two years.

If B's business is a non-qualifying business, or its gross assets exceed the permitted limit, or if B controls companies which are not qualifying subsidiaries or is itself under the control of another company, or of another company and a connected person, then any shares issued by B to a VCT will only be treated as VCT qualifying holdings for a period of three years and any securities issued by B will only be treated as VCT qualifying holdings for a period of five years. However, if the shares and securities held by the VCT in A were non-qualifying then these periods are reduced to 12 and 18 months respectively.

This is a very brief summary of some very tricky rules. Great care is required.

General considerations under both the EIS and VCT rules

Whatever sort of business combination is considered great care must also be had to the impact a merger might have on a new company's continuing ability to comply with certain EIS and VCT rules where future EIS and/or VCT fund raisings are contemplated. For example the requirements limiting the gross assets of a qualifying company; the lifetime limit of the relevant investments that can be made, taking account of former subsidiaries and transferred in trades; and the age limit restriction which counts down from the first commercial sale of any member of the new group: all these requirements require very careful consideration.

More generally, where technical solutions are proposed to address or work around tax constraints an additional consideration is whether a proposed solution would be vulnerable to an application of the "general anti-avoidance" rule ("GAAR") (or indeed anti-avoidance case law principles) to counteract any perceived tax "advantage" thereby obtained. For these purposes, ensuring a potential tax charge does not arise can constitute a tax advantage.

Broadly, in order for the GAAR to be capable of application to particular transactions or arrangements, there must be abusive tax arrangements. Arrangements are “tax arrangements” if, having regard to all the circumstances, it would be reasonable to conclude that the obtaining of a tax advantage was (one of) the main purpose(s) of the arrangement.

Given that the concept of “tax arrangements” is widely drawn, the central question in the context of some of the possible solutions to achieve a tax efficient merger or reorganisation as mentioned here will be whether the relevant arrangements are “abusive”.

In order to work out whether the tax arrangements are abusive the so called ‘double reasonableness’ test has to be applied. Tax arrangements are “abusive” if they are arrangements the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions, having regard to all the circumstances, including the principles on which the relevant tax provisions are based and the policy objectives, whether there is any contrivance or artificial or abnormal steps.

However, the commercial context is also relevant, and taking an “in the round” approach one might well conclude in many cases that the double reasonableness test is not satisfied. Nonetheless, any potential for the application of the GAAR is another risk to be taken into account when considering any structuring proposal for a merger or reorganisation of EIS and VCT companies.

Along similar lines, the question of whether the transactional solution proposed for any particular situation may be a “notifiable arrangement”, requiring a disclosure to HMRC under DOTAS, may also need to be considered. Very broadly, a notifiable arrangement requires an arrangement: (i) where a tax advantage is the main or one of the main benefits that might be expected to arise; and (ii) which is an arrangement of a type specified in Treasury regulations (“the hallmarks”). Even if one were to assume that the main benefit test may be satisfied, no notification under DOTAS should be required if the solutions proposed would not engage any of the hallmarks.

Finally, in the real world, many EIS and VCT funded companies that run into trouble or need to merge in order to be in the vanguard of successful businesses growing in a competitive market will have both EIS and VCT investors and the concerns of both, under the different rules of each scheme, will need to be addressed; - particularly if they will be asked to invest again in the future.

Roger Blears
RW Blears
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Christine Ward
RW Blears
6 February 2024