Integrating S/EIS & VCT provisions into corporate deals

The Seed Enterprise Investment Scheme ("SEIS"), Enterprise Investment Scheme ("EIS"), and Venture Capital Trust ("VCT") scheme are the three tax-based Venture Capital Schemes ("VCS") available to UK taxpayers. VCS are designed to encourage individuals to gain exposure to, either directly or indirectly, smaller unquoted higher risk trading companies. The VCS framework is set out in Part 5, Part 5A, and Part 6 of the Income Tax Act 2007 ("ITA"). Application of the ITA is a key feature of the process for early stage companies raising capital from investors (whether they be individual angel investors, S/EIS funds, or VCTs).

This article covers how VCS provisions are incorporated into the fundraising process – from the initial assessment as to whether a company qualifies for the related schemes, to the relevant terms incorporated into a company's constitutional documents to ensure compliance at the outset of an investment and for the relevant period following completion.

Does the company qualify for S/EIS & VCT funding?

Where investors are seeking to claim S/EIS relief, their investment will often be conditional on the investee company first making an application to HMRC for advance assurance ("AA"). The AA is a non-statutory service offered by HMRC on a discretionary basis, where HMRC may offer an opinion as to whether a prospective investment would be a qualifying investment. Although not compulsory, by obtaining AA a prospective investee can give prior comfort to its incoming investors that upon completion the company will be authorised to issue compliance certificates in accordance with the ITA.

In general, companies seeking an investment from a VCT should not need AA from HMRC. VCTs are able to rely upon their professional advisers to determine if a prospective investment is qualifying or not. HMRC will expect a VCT to take all reasonable steps to ensure an investment would be qualifying; this includes acting on professional advice specifying the technical basis upon which the proposed investment would meet each requirement in Chapter 4 of Part 6 ITA 2007.

Whether an application for AA or a professional opinion is sought, the strength of the application or opinion is dependent on the quality and accuracy of the information provided and the rigorous application of the VCS legislation to the relevant fact pattern. Given the importance of establishing whether a company qualifies for VCS, much of the assessment and analysis will be carried out by professional advisers up front in the early stages of a funding round.

For all schemes, there are a number of supporting documents and information to be provided, a list of which can be found at GOV.UK. There is a fair level of due diligence and analysis to be carried out, and parties should ensure this process is factored into the overall transaction timeframe and key lead investors are aligned on how the process will be managed.

Structuring the transaction – points to consider

Split Completions

Companies undergoing a seed investment round will likely be within the limits to offer both SEIS and EIS schemes. SEIS funding is available at the first instance on a maximum amount of £250,000. Thereafter EIS funding is available up to a maximum amount of £12million, or £20million where the company qualifies as knowledge intensive.

One important structuring characteristic for fundraises combining SEIS and EIS relief is a requirement to issue SEIS shares and EIS shares at least one day apart from one another. Thus the transaction documents for a combined SEIS and EIS fundraise should contain split completion mechanics to accommodate the SEIS and EIS subscriptions sequentially, with the company's register of members being written up on the day in question to clearly record two separate share issue dated.

SEIS and EIS shares must be paid up in cash; board resolutions should note that an allotment and issue of shares is subject to receipt of subscription monies. An undertaking to pay cash is not sufficient. There are cases where tax relief is not granted because of corporate administrative errors.

Gross assets

Companies undergoing either a very early stage or later stage fundraise should also carefully consider the gross assets test. In a SEIS context, the gross assets of the company (or group where the issuing company is a parent company) must not exceed £350,000 immediately before the relevant shares are issued (s.257DI ITA 07). For an EIS or VCT fundraise, the gross assets must not exceed £15m immediately before the issue of shares and £16m immediately after the issue of shares (s.186/297 ITA 07). Importantly, where a company's (or group's) gross assets exceed the stipulated thresholds at a point in time, the gross assets test may subsequently be met where the figure drops below these thresholds. This is particularly helpful for companies that have a high cash burn rate and they may be able to plan a future EIS and/or VCT raise if the financial forecasts indicate a dip in gross assets and the remaining provisions of the EIS and/or VCT legislation continue to be met.

On larger Series A and Series B funding rounds which would result in a breach of the gross assets tests in light of large round size, a dual completion mechanic can be considered to allow EIS/VCT investors to complete their investment a day before the remainder of the round.

Advance Subscription Agreements ("ASAs") – SEIS & EIS only

Under EIS and SEIS strict rules apply as to when investment must be made for the issue of shares to qualify for relief. Shares must not also be issued in consideration of the release of debt or the conversion of loan stock (*sections 174* (EIS) *and 257CB* (SEIS) *ITA 2007*). This is in contrast to VCTs, which are permitted (subject to at least 10% of their holding in a company being in the form of eligible shares) to subscribe for convertible loan stock.

Practical difficulties arise where companies need to raise funds quickly but wish to do so under EIS or SEIS, if investors require AA (which can take time to obtain) or as part of a funding round (for example if the shares need to be valued). ASAs are often used to circumvent these issues. An investor will pay money under the terms of the ASA; but the shares are issued at a later stage, for example on a funding round.

HMRC's guidance sets out what it considers to be necessary for shares issued pursuant to an ASA to qualify for EIS or SEIS relief on the eventual issue of the shares:

- The ASA must not function as a loan agreement or an investment agreement which offers investor protection. HMRC expects that the company will demonstrate how the timing and terms of the ASA fit with its business plan.
- There should be no provision for refunding the payment. Nor should it be possible to vary, cancel or assign the agreement.
- The ASA must have a longstop date which HMRC expects to be no longer than six months from the date of the ASA.

- HMRC states that it expects a company wishing to obtain AA to do so before entering into an ASA.

In practice, investee companies will need to consider the timing and terms of ASAs carefully, in particular considering whether they are more investor friendly than HMRC considers acceptable. Companies will also need to consider timing for AA.

Investment documentation – points to consider

Articles

S/EIS and VCT provisions play a key part in determining how the share rights in a company's articles will be structured. Qualifying shares must be structured in such a way that does not confer any present or future preferential right to dividends or to a company's assets on its winding up, or any present or future right to be redeemed. The restrictions are less stringent in the context of a sale; therefore one may see priority rights given to S/EIS and VCT share classes in the sale waterfall. One may also see more complex liquidation preferences than on non-S/EIS and VCT investments.

Furthermore, a qualifying company must not be under the control of another company. As an ongoing protective measure, corporate limiters can be used to prevent corporate shareholders from having more than a 50% entitlement on dividends, voting and return of capital.

Subscription and Shareholders' Agreement ("SSA")

Institutional EIS/VCT investors will typically expect the SSA to include warranties with regard to the information provided for the purposes of an AA application or legal opinion, which should be complete, true, and accurate in all material respects from the time it was given up until the point of investment. Further, the SSA will contain governance provisions for ensuring S/EIS and/or VCT legislation is complied with for the duration of the investment. Such provisions will include: (i) a use of monies obligation on the company to apply S/EIS and/or VCT investment funds towards the growth and development of the company, (ii) a list of matters requiring consent of the S/EIS and/or VCT investor with respect to certain operational matters that if left unchecked could have an impact on compliance (for example, any entry into partnerships or joint ventures, or any change in business activities to something that is non-qualifying), and (iii) covenants given by the company and management team to comply with the relevant provisions of the ITA, to notify investors if there are any risks of non-compliance, and to carry out the reasonable directions of the investors (or the investor director) if such risks arise. On later funding rounds when larger non-EIS/VCT institutional investors participate the EIS/VCT compliance provisions and restrictions often becomes a commercial point for negotiation as new investors might not be happy with the degree of control conferred on earlier investors.

A few common pitfalls/risks to reliefs/qualifying holding status to watch out for

Existing shareholdings

Investors holding non-S/EIS shares in a company cannot claim S/EIS relief.

Leaver scenarios

Where shares are being bought back by the company in a leaver scenario, the knock-on effect is to deliver value to the wider shareholder base due to the reverse dilutive effect of a share buyback. This in turn can lead to a claw back of EIS relief. As such, it is common to see a consent right for S/EIS and/or VCT investors with regard to any share buyback being carried out.

The use of deferred shares should be approached with caution so as not to inadvertently create preferential rights for the S/EIS and/or VCT qualifying share class, or breaching the independence requirement.

Equity incentive

Where growth shares are being implemented (either as part of or post completion of an investment) care should be taken so as not to inadvertently create preferential rights for the S/EIS and/or VCT qualifying share class.

Early disposals of shares

S/EIS investors cannot grant options over their shares until after their S/EIS investment's termination date – generally three years (but not always) from the date their shares were issued. A sale prior to the end of the termination date will result in loss of the S/EIS tax relief. There are some ways of locking in a sale if one does receive an offer before the end of the three year period but advice should always be taken.

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