Napkin numbers

NICOLE NEVILLE explains the benefits of an investment in shares that will qualify for tax reliefs under the enterprise investment scheme.


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I was looking forward to meeting up with my brother for lunch. We hadn't got together in a while and he said he had something to celebrate .... so lunch was on him.

'So, Bob what are we celebrating?' I said, after having chosen the most expensive dish on the menu.

'Remember that hideous sculpture that great aunt Mavis left me in her will?' replied Bob. 'Well, it was valued at £7,000 at probate, but I've just had it re-valued and it is worth about £50,000. This unknown sculptor is experiencing a meteoric rise to fame. I am going to take it to auction and – who knows – I might be lucky and receive even more.'

'Lucky you,' I said, with only a touch of jealousy as I remember the chipped dinner set that I was bequeathed. But, moving on, at least I'm getting a free lunch.

'So,' Bob said, 'I have been thinking about how to invest my windfall and Barbara suggested I should invest in her company Babs' Bags for Babes Ltd. She said she wanted to expand the product range and was looking for an investment of £40,000.

The background on Babs' Bags

Reader, let me fill you in. Bob's girlfriend Barbara is quite the rising star. Five years ago, she set up her own company designing and selling bags and now has a shop in central London as well as a significant online presence. Only last week, she was bragging about how she now employs 50 staff and her latest balance sheet shows the company has assets worth £8m. Luckily for me, Barbara is incredibly generous; I now have handbags for every day of the week, courtesy of Babs' Bags for Babes.

We call the waiter over and I make it clear that I am intending to have three courses and that buying a bottle of wine would be far more cost-efficient than ordering by the glass.

Bob continued: 'Barbara mentioned something about me being entitled to tax relief if I invest in her company. Since you are a tax tutor I was hoping you could explain to me how it worked,' he said in a wheedling tone.

Ah well, clearly I was wrong; apparently there is no such thing as a free lunch.

So, as we tucked into our smoked salmon and avocado starter, I explained that income tax relief is available if a *qualifying investor* subscribes for shares in a *qualifying EIS company*.

Subscribing for shares means that Bob must buy freshly issued shares from Barbara's company. The income tax relief is given by way of a tax reducer calculated at 30% of the value of the shares subscribed for (up to a maximum subscription of £1m).

'Ooh, so I will get tax relief of £12,000 for this tax year?' said Bob, looking excited.

'Well, let's look at the numbers' I replied. 'You are earning £50,000, so your tax liability for 2018-19 would be £8,360. I scribble down a basic income tax computation on ***My napkin*** showing how this amount is calculated.

I explained that, having calculated the normal income tax liability, the EIS relief is deducted from this amount. So, if Bob subscribed for £40,000 worth of shares in Babs' Bags for Babes

Key points

- Tax-efficient enterprise investment scheme relief for shares in a company.
- The subscription must be for newly issued shares.
- Income tax relief is by a tax reduction at 30% up to a maximum subscription of £1m.
- The reduction or part of it can be carried back to the previous year.
- The investor and associates must own no more than 30% of the company, nor be employees.
- Special provisions allow a director to be eligible for EIS relief
- The company must meet specific conditions.
- An investment can be eligible for capital gains tax deferral relief.
- Capital loss on EIS shares can be set against income.

My napkin

Bob's income tax computation 2018-19

	£
Employment income	50,000
Less: personal allowance	11,850
Taxable income	38,150
Income tax: £35,500 x 20% =	6,900
£3,650 x 40% =	1,460
	8,360
Less: Income tax reducer (£40,000 x 30%) = £12,000 but restrict to:	8,360
Income tax liability	NIL

Ltd, this will give a tax reducer of £12,000. But, because his tax liability is only £8,360, the relief can only reduce the liability to £nil. Consequently, the reduction will also be only £8,360.

'So, what happens to the tax I have paid at source through PAYE?' asked Bob.

'Don't worry – this will be repaid to you,' I confirmed.

'That makes sense,' said Bob; 'But I would not get the full benefit of the tax reducer. Maybe I should tell Barbara that I will invest just £27,867 in her company.'

Bob's prowess at mental arithmetic never fails to amaze me. He is indeed right – an investment of £27,867 will give him a tax reducer exactly equal to his tax liability as £27,867 x 30% = £8,360.

'But it is possible to carry back an EIS subscription to the previous tax year (2017-18) so long as you have not used up any of your limit for that year,' I said. 'So, if you wanted to invest £40,000, you could get a tax reducer for the full subscription.'

Bob's face brightened, 'That's great. Barbara was so keen for me to invest the full £40,000, she even offered me a directorship as a sweetener. I was going to help set up a new line in man bags. Barbara said I would be her business angel…,' he said, staring into the distance looking all misty-eyed.

'Well,' I said, 'before you consider any career changes you will need to make sure that you meet the conditions required to be a *qualifying investor*, otherwise you will not get the income tax relief.'

A qualifying investor

This is an investor who is not connected to the company. I told Bob that there are two main conditions to achieve this:

- The investor, together with their associates, must not own more than 30% of the shares in the company.
- Neither they nor their associates can be an employee of the company.

An associate includes spouse, parents and children.

'I know my investment will not come to anywhere near 30% so I will certainly meet the first condition,' Bob replied. 'But it seems I will have to turn down the directorship if I want to get the income tax relief,' said Bob despondently. And I thought we could rebrand the company as "Bob and Babs' Bags for Blokes and Babes".'

'Ah,' I said, 'but there are special provisions which allow a director of a company to be eligible for EIS relief and so obtain income tax relief on a subscription for shares.

'First, existing directors can obtain relief if they are unpaid.'

'Well that doesn't apply to me,' interjected Bob.

'Second,' I continued, 'there are special provisions that apply to someone who is not connected to the company before the share issue and then becomes a paid director after the share issue and receives reasonable remuneration for the work he does.'

'Hoorah,' said Bob, 'So I would be a qualifying investor. But you did also mention that Barbara's company must be a *qualifying company* for tax relief to be available on my investment.'

'Glad to see you have been paying attention,' I replied.

A qualifying company

From what I know of Barbara's company it does seem to meet the conditions. As we chew on our steaks and chunky chips I ran through them.

The business is an unquoted, trading company. Some trades are excluded, but not design and retail of bags. The company must be relatively small, so its assets must not exceed £15m before the share issue and must not exceed £16m after it. Neither must it have 250 or more full-time equivalent employees. Also, the company must use the cash invested within two years for some sort of trading purpose.

'This is great news,' said Bob. 'I am hoping that I will be able to sell the shares at a profit in about two years' time. Barbara's brother mentioned that he might be interested in buying the shares from me so if I can sell them to him at a profit that might pay for our dream wedding.' The misty-eyed look returned.

'Oh dear', I responded, 'I think you might want to postpone the wedding!'

'What? Why?' asked Bob.

'Well, if you sell the shares within three years of issue there will be a clawback of the relief originally obtained.'

'Oh no, so the full tax reducer of £12,000 will be clawed back?'

'That's right. And then, of course, you will have to pay capital gains tax if you make a profit.'

Bob looked so miserable. 'But if it's any consolation,' I continued, 'if the shares fall in value and you sell at a loss within three years then the relief clawed back is limited to the sale proceeds multiplied by 30% and you will have an allowable capital loss.'

The confused look returns.

Calculating a capital loss

I thought that a simple example would help to illustrate this. Say the shares fall in value to £10,000, there would be a clawback of relief of £3,000 (£10,000 x 30%). This means £9,000 of the original £12,000 income tax reducer would be retained.

I grabbed ***Bob's napkin*** and showed him how the capital loss would be calculated.

Bob's napkin

		£
Proceeds		10,000
Less: cost	40,000	
Less: Income tax reducer retained (12,000 – 3,000)	9,000	
		31,000
Allowable capital loss		21,000

The cost of the shares is reduced by the income tax relief retained, thus reducing the allowable loss to £21,000.

'But what use is a capital loss to me?' asked Bob.

'You would be able to offset it against any capital gains made in the same tax year and then carry forward against future gains, which I appreciate might not be that useful if you don't expect to have any capital gains in the future. Further, in this unique situation, if the capital loss is on shares that qualified for EIS relief, it can be set against your *income* of either the year in which the loss arose and/or the previous year.'

'That is much more generous,' Bob conceded. 'But I'm sure the company will do well and the shares will go up in value.'

'If that is the case, you should keep the shares for at least three years so there will be no clawback of income tax relief and any potential capital gain is exempt.'

'Well, I think Barbara will understand if we delay the wedding a little under the circumstances.'

Reinvestment relief

Finally, a smile returned to Bob's face, but it quickly turned into a frown. 'If I use the proceeds from the sale of the sculpture I inherited to pay for the shares, will I have to pay capital gains tax on the profit?'

I could see this was going to be a long afternoon. As we tucked into chocolate brownies and coffee, I cheered him up by explaining that he could claim EIS reinvestment relief.

'EIS reinvestment relief allows the gain on any asset to be deferred, as long as the proceeds are reinvested – within 12 months before the disposal and 36 months after – in qualifying EIS shares. Not only that, but you can choose how much gain to defer so you can get make sure you get the full benefit of the annual exemption.'

I grabbed a ***Spare napkin*** and did some calculations. 'The gain on the sculpture is calculated as the proceeds less probate value. Assuming you sell it for £50,000, you will have a gain of £43,000. So you should make a claim for EIS reinvestment relief of £31,300. This will leave you with a chargeable gain of £11,700 exactly equal to the annual exemption. This then means that the taxable gain is nil.'

'But you mentioned that this relief is a deferral relief,' replied Bob. 'Doesn't that mean that this gain is postponed and will become chargeable later?'

'That's right,' I responded. 'The deferred gain of £31,300 is frozen until a chargeable event occurs. The most common chargeable event is the sale of the EIS shares.'

Spare napkin

	£
Proceeds	50,000
Less: Cost = probate value	7,000
	43,000
Less: EIS reinvestment relief	31,300
Chargeable gain	11,700
Less: annual exemption	11,700
Taxable gain	NIL

'OK, so let me get this straight,' said Bob. 'When I subscribe for shares in Barbara's company I will get an income tax reducer of 30% of my subscription. If I use the proceeds from the sale of the sculpture I can defer the gain on it.'

I nodded encouragingly.

'Then I keep the shares in the company for at least three years to make sure that the income tax reducer is not clawed back.

'Finally, if I wait at least three years to sell them, any gain on the shares will be exempt, but the frozen gain on the sculpture will become chargeable.'

'You got it,' I said proudly.

Time for the bill

It was time to ask for the bill. The waiter had been hovering near our table for a while and we were the last diners in the restaurant. I called him over to ask for the bill.

'I hope you don't mind, but I couldn't help but overhear some of your conversation,' he said. 'I am studying for my ATT exams and I have just been learning about seed EIS relief. Wouldn't your brother be better off claiming that because he would be entitled to a 50% tax reducer?'

'You are right, we should consider this relief,' I replied, putting a polite smile on my face to mask my surprise at his intrusion into our private conversation. 'But the company we are considering is not a qualifying SEIS company.'

Now over to you dear reader ... can you identify three reasons why Babs' Bags for Babes Ltd is not a qualifying company for SEIS reinvestment relief? The answers can be found on page 26. And award yourself a nice lunch if you spot them all.

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Alternative basis

Wayleave payments for business property.

A new client receives wayleave payments from electricity installations on his business property. He is self-employed and has previously included these receipts with his self-employment income (see HMRC's *Property Income Manual* at tinyurl.com/HMRC-PIM1118). However, with the introduction of the property income allowance, can he now separate out the wayleave 'rent' and not pay any tax on it? The amount of the wayleave income falls within the £1,000 allowance and he has no other rental income. I look forward to hearing from readers.

Query 19,229 *– Energetic.*

ITTOIA 2005, s 346 provides an alternative basis of charge.

Rent received for a UK electric line wayleave is normally taxed as property income under ITTOIA 2005, s 344. However, ITTOIA 2005, s 346 provides an alternative basis of charge at the option of the taxpayer. This provides that rent from wayleaves and any related expenses may be brought into account as trading income under ITTOIA 2005, s 22 if specific conditions are met:

- the taxpayer is carrying on a trade on the land where the wayleave is situated;
- rent is receivable or expenses are incurred by the trader in respect of the wayleave;
- no other income or expenses related to this land is taxed as part of a property business.

There is no statutory mechanism for this election, so it is simply made by inclusion in a tax return. It appears that Energetic's client meets the above conditions and he has correctly included the income as part of his trade.

ITTOIA 2005, s 783B to s 783BQ introduce a 'property allowance' from 6 April 2017, which exempts the first £1,000 of property income (with no deduction for expenses). The allowance is available on all property income with specific exclusions for 'rent a room' income, distributions from some property funds, and income from connected parties. Income from wayleaves is not excluded, so the allowance is available.

The inclusion of the wayleave income as trading income in previous years does not affect this analysis because this is an election at the discretion of the taxpayer. Because the election was made by inclusion in the tax return, it applies to each tax year independently and is not binding on subsequent years. Energetic's client can claim the allowance. *– ANA.*

Wayleaves can be treated as part of the trading profits in some cases.

Energetic refers to HMRC's *Property Income Manual* at PIM1118 which, in turn, refers to ITTOIA 2005, s 22. This provision allows wayleaves to be treated as part of the trading profits in specific situations:

- that a person (the trader) carries on a trade on some or all of the land to which the wayleave relates;
- rent is receivable, or expenses are incurred, by the trader in respect of the wayleave; and
- apart from the transactions in relation to the wayleave, the trader does not have any other property business transactions.

There is corresponding provision (in s 344 to s 348) for wayleaves for UK electric lines received in relation to land from which other property income is derived, although this will not affect the application of the property income allowance.

Notably, these provisions are permissive, not mandatory, and would seem to apply year on year rather than have to be permanently opted into.

As such, I cannot see any reason why, in future, the wayleave profits to which Energetic refers cannot be treated as property income.

The property allowance will then apply, in effect, to exempt the income from taxation. *– Milburn Pennybags.*

Babs' Bags for Babes Ltd

Reasons why Babs' Bags for Babes Ltd would not be a qualifying SEIS company.

Tax relief under the seed enterprise investment scheme will be given only if the subscription for shares is in a company that qualifies as follows.

- An unquoted trading company with a permanent establishment in the UK.
- Prohibited trades include financial trades, farming, market gardening, hotel and property development.
- Company's assets must not exceed £200,000 before the share issue.
- Company must employ less than 25 full-time equivalent employees.
- The cash raised by the issue of SEIS shares must be used for the trade within three years.
- The qualifying activity must be a trade less than two years old.

Babs' Bags for Babes Ltd would not qualify for SEIS because:

1) it has £8m of assets;
2) it has 50 employees; and
3) it was established five years ago.