Enterprise Investment Scheme

Philip Hammond eyes new patient capital EIS funds

Plan could expand the ways investors apply tax relief

Chancellor Philip Hammond leaves 11 Downing Street to deliver his Spring Statement © AP

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Wealthy investors could offset tax bills against investments in some of the UK's riskiest early-stage companies in the future, following the launch of a consultation at the Spring Statement this week amid soaring popularity for tax-efficient investments.

In his speech, Philip Hammond, the chancellor, mooted a new kind of higher-risk Enterprise Investment Scheme (EIS) fund that could allow investors to write off chunks of a capital gains tax (CGT) bill or even offset old income tax liabilities, as long as they invested in the highest-risk start-ups, known as knowledge-intensive companies.

EIS funds were set up by the government in the 1990s to encourage investment in high-risk start-up companies. They offer tax relief to those willing to invest in some of the UK's most illiquid companies and have grown popular with wealthy investors capped out of making further savings into a pension.

The funds are also increasingly being targeted by the government as a way of funnelling long-term capital towards nascent UK businesses in an attempt to rival the entrepreneurial culture in countries such as the US.

Currently, investors receive 30 per cent income tax relief on their investments and can defer capital gains tax liabilities by investing in an EIS investment.

But the new fund could offer one of four different kinds of tax relief, including being able to write off parts of a CGT bill — for example from the sale of a property — by reinvesting it in the EIS fund.

Currently, investors in EIS can defer CGT bills, but not exempt them.

“The CGT option would be appealing to anyone with a large property gain, as CGT on property attracts a higher tax rate of 28 per cent,” said Jason Hollands, managing director of Tilney, a wealth manager. “On shares or most other gains, CGT is low enough that it might not be worth going into a higher-risk investment to defer it.”

Another option the consultation will explore would be awarding income tax credits in the year the EIS investment was made, or further back. Under the current model, investors receive tax relief when the fund invests in an underlying company, meaning they cannot control when they receive the relief and making it harder to use EIS funds for tax planning.

Investors could also receive dividends from EIS companies free of tax after holding them for a certain period.

Any new fund would have to target knowledge-intensive companies — those with high research and development spends at very early stages of development. Currently, not all EIS funds invest in such companies and might be lower risk.

Mark Brownridge, director-general of trade body the EIS Association (EISA), said: “These are high-growth companies but are very risky at the same time. You might not see returns for five or seven years at least [in a fund like this], it is truly patient capital.”

As interest in EIS investments rises, the government has been cracking down on schemes that offer generous tax relief without taking enough risk.

The new finance bill, expected to receive Royal Assent this month, will ban certain kinds of EIS investments that do not put investors’ capital at sufficient risk. In the current tax year, money has flowed into EIS funds that are expected to be hit, including those investing in pub chains and crematoria.

Oxford Capital Media EIS, which invests in film sales agents, was able to hit its annual target raise of £10m last August — just five months into the tax year. The EIS raised a total £2.4m in the 2016-17 tax year.

Investors seeking tax-efficient ways to shelter their investments have also been turning to venture capital trusts (VCTs) in record numbers this tax year.

With three weeks to go before the end of the tax year, VCT fundraising is already at its highest level in over a decade. By March 13, £557m had poured in to VCTs, beating the £542m raised in the previous tax year and far higher than the amounts raised in each of the four previous tax years.

VCTs offer 30 per cent income tax relief up to a £200,000 annual limit. Unlike EIS funds, they are listed and contain a bigger pool of early-stage companies. They also offer tax-free dividends.

Alex Davies, founder of Wealth Club, a broker, said: "The increased demand does not come as a surprise, as higher earners, who can no longer invest vast sums in pensions, continue to seek out a tax-efficient alternative.

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Jason Hollands, managing director, Tilney

"Reductions to the lifetime allowance and annual allowance, along with increased dividend tax and the crackdown on buy-to-let, only serve to perpetuate this demand."

Mr Hollands added: "The first port of call for someone who has maxed out their pension and Isas should be to look at VCTs, which have between 30-75 holdings, are run by a manager and have a £200,000 allowance, meaning you can shelter £60,000 of income tax."

At the end of last year, Octopus Titan venture capital trust broke the record for a VCT fundraising round after gathering £120m in the last four months of 2017.

It is now offering an additional £80m of fundraising capacity. If it hits its £200m target this will be the largest ever fundraising by a VCT.

Although there was no mention of VCT investments in the Spring Statement, last autumn's Budget flagged that VCTs would have to invest in higher-risk schemes in the future and put their money to work faster.

Mr Hollands said: "The sweeping powers HMRC now has to crack down on aggressive, loophole-driven tax schemes means — quite rightly — that demand for legitimate, approved tax efficient investments is riding high."