Dearly departed

Is death the end? KEVIN SLEVIN explains that it can be for the tax relief on shares purchased by some venture capitalists.

This article primarily concerns the impact of death: the dead can't speak for themselves so it's about time that someone spoke out on their behalf. And when it comes to the venture capital schemes, there is more to dying than might appear at first sight. The state often "robs" deceased venture capitalists (or, to be more precise, the deceased's beneficiaries) of a valuable tax break lawfully promised to the deceased in his lifetime. To see how this robbery takes place it is necessary to devote a little time to exploring the background to some of the venture capital schemes, by which I mean:

- the enterprise investment scheme (EIS);
- share loss relief (SLR); and
- the venture capital trust scheme (VCT).

For the sake of brevity, I have ignored the seed enterprise investment scheme (SEIS). My main concerns are shares acquired within the EIS regime and SLR. The central aim of venture capital schemes is to help smaller higher-risk trading companies to raise finance by encouraging individuals to take equity stakes by subscribing for shares. Because I have focused on investments made by individuals, the capital gains tax deferral relief element of EIS applicable to certain trust gains, the SLR available to companies, and the corporate venturing scheme are not addressed.

EIS in a nutshell

Put briefly, where a qualifying individual subscribes for shares in a qualifying company, and both the individual and the company comply with the EIS provisions, the individual can claim income tax relief on the cost of his investment (up to £1m in any one tax year with the relief being limited to the income tax otherwise payable for the year). In addition, if the investor retains the shares for at least five years, any gain arising on their sale will be exempt from capital gains tax. Of course, there is a lot more to EIS provisions than the foregoing might suggest, but this brief summary is all that is required for the purposes of this article.

What is more, if things do not work out, and the investment is disposed of at a loss, the loss (as reduced by the income tax relief enjoyed) may be set against income for income tax purposes under the SLR provisions.

To illustrate these tax reliefs, we can explore the situation where, on 1 July 2012, Tom makes what he appreciates is a high-risk equity investment of £100,000 in EIS (2014) Ltd in the belief that the company's potential is great. Tom's view of the situation is that he stands to make a substantial gain if all goes well and, thanks to EIS, this gain should be tax exempt. Most such investment decisions are marginal and Tom is heavily influenced by the tax exemption he believes will apply in the short term. However, he also takes comfort from the fact that, should things go wrong and he loses his capital, income tax relief will be available to partly defray such a loss.

Alas, one thing which Tom did not anticipate was that, on the second anniversary of the issue to him of the shares in EIS (2014) Ltd, he would be killed in a car crash driving home from the company's annual general meeting. Let us assume also that:

- all the EIS conditions have been satisfied both at the outset and through the period ending on the date of death;
- full income tax relief was enjoyed on the £100,000 investment (and none clawed back); and
- the EIS shares were worth £150,000 in the open market at the date of death.

KEY POINTS

- The death of the investor can cause loss of tax reliefs.
- EIS shares can lose capital gains tax exemption under TCGA 1992, s 150A(2).
- A lifetime transfer can preserve EIS tax exemption.
- Compare the position with venture capital trust investments.
- Is it right that tax exemption depends on foreknowledge of death?

TOM'S SHARES

Scenario 1: Sale by EIS investor (ie if he had lived)

	£
1 July 2019 Tom sells his shares in EIS Ltd – Proceeds	5,100,000
1 July 2012 Tom acquired his shares in EIS Ltd – Cost	100,000
Gain	5,000,000

Here, the capital gains tax position is that the £5m capital gain is exempt from tax under TCGA 1992, s 150A(2).

Scenario 2: Sale by widow of EIS investor

	£
1 July 2019 Tom's widow sells shares in EIS Ltd	
– Proceeds	5,100,000
1 July 2014 Shares deemed to be acquired by	
Tom's widow at probate value	150,000
Gain	4,950,000

It will be seen from scenario 2 that the impact of the death of the EIS investor is the loss of the capital gains tax exemption as regards the post-death growth in value and, unlike the position in scenario 1, no part of the £4.95m capital gain is exempt. Assuming the gain is fully taxed at 28% because Tom's widow was neither an officer nor an employee of the company, tax of £1,386,000 will be due.

Tom's Shares contrasts the capital gains tax position arising on, first, a sale of the EIS shares had Tom lived to sell the shares personally on the seventh anniversary of their acquisition with, second, the position arising on a sale taking place on the same date, but by his surviving spouse (assumed to have inherited the shares on her husband's death). It assumes that the shares are sold for £5,100,000.

Lifetime gift?

The position in ***Tom's Shares*** can be contrasted with the situation where the EIS investor has some notice of his pending death and has the opportunity to give the those shares to his wife before he dies. Thus, the widow acquires the shares in EIS Ltd by virtue of a lifetime gift from her husband and not under his will or intestacy.

Let's say that Tom is not killed in an accident but is diagnosed with cancer and is given just three months to live. Tom is advised to gift his shares in EIS (2014) Ltd to his wife during his lifetime rather than letting them pass to her under the terms of his will. Here the position on the ultimate sale is much more tax advantageous as shown in ***Tom's Lifetime Gift***.

For the sake of completeness, in ***Tom's Lifetime Gift***, if Tom's widow were to die before disposing of the shares, any growth in value after *her* death will not attract the capital gains tax exemption.

Schedule 5B deferral relief

Of course, there is more to EIS than the reliefs outlined above. Those who have the confidence to seek out government-inspired tax breaks may have been advised that they can shelter certain existing capital gains by making a qualifying EIS investment. This is a totally different dimension from the EIS provisions. Indeed, the qualifying conditions applicable to the deferral relief are not as stringent as they are for taxpayers seeking income tax relief. Income tax relief (and the potential capital gains tax exemption) is not available where the investor is connected with the company. Broadly speaking, if a person has more than 30% of the ordinary share capital of a company, more than 30% of the loan capital and the issued share capital, or more than 30% of the voting power, they will be considered to be connected with that company. In addition, employees of the company will be connected persons (although there are certain special rules for unpaid directors and certain business angels).

This can be contrasted with the situation as regards EIS deferral relief under TCGA 1992, Sch 5B where the relief is available even if the investor acquires 100% of the issued share capital of the qualifying EIS company and he is the only employee. This greater flexibility increases the scope for tax planning, not least in the case of individuals who discover they are terminally ill. Looking at matters dispassionately, the EIS deferral relief can be claimed with a view to the relief morphing into a permanent exemption from capital gains tax.

Schedule 5B provides (quite separately from the income tax relief referred to above) that, for every £1 of qualifying EIS investment made by an individual, he or she can claim deferment of the assessment of otherwise assessable eligible capital gains. Gains potentially eligible for deferment under Schedule 5B are:

- those made in the three-year period preceding the making of the EIS investment (normally the date of the valid issue by the EIS company of the share certificates); and
- those made by the individual in the one-year period after the issue of the EIS shares.

While the shares in question must be issued to the EIS investor before his death (otherwise no relief of any kind will

TOM'S LIFETIME GIFT

Scenario 3: Sale of shares acquired by lifetime gift

	£
1 July 2019. Tom's widow sells shares in EIS Ltd	
– proceeds	5,100,000
25 June 2014. Shares acquired by gift	
– deemed cost (TCGA 1992, s 58)	100,000
Gain	5,000,000

In these circumstances, the £5m capital gain is exempt from tax under TCGA 1992, s 150A(2). In effect, the exemption potentially available to Tom as the original EIS investor attaches to the shares passed to his wife during his lifetime. The gain on the ultimate disposal remains exempt, unlike the position in ***Tom's Shares*** where a transfer of shares to the widow on Tom's death brings an end to the exemption.

be due), it is not essential that the terminally ill investor survives to make the claim for relief. The claim can be made by the deceased shareholder's executors (or personal representatives) as long as the form EIS 3 is lawfully issued by the company and the claim is made before the fifth anniversary of the normal tax return filing deadline for the tax year in which the shares were issued.

When advising a terminally ill client, the making of the investment is the first step of the exercise. The second step occurs when the investor dies still owning the EIS shares (and without any of numerous conditions of the relief having been breached before the date of death). On death, the hitherto "deferred capital gain" falls totally out of account for capital gains tax purposes; the deferred gain is, in effect, converted into a de facto exempt gain.

The foregoing reflects the outcome of the legislation rather than a specific provision relating to death. Subject to certain special provisions (seldom having application in practice), once deferment under Sch 5B is achieved, this deferment will cease only if one of the following circumstances arises:

(a) the investor disposes of those shares (otherwise than by way of a disposal within marriage or civil partnership);
(b) the investor becomes a non-resident while holding those shares and before the "termination date" relating to those shares in question;
(c) the shares in question cease to be eligible shares (as defined) before the relevant termination date; or
(d) the shares in question are deemed to have ceased to be eligible shares before the relevant termination date (for example, under the "value received provisions" of Sch 5B para 13(1)(b)).

HAMISH

Hamish makes an EIS qualifying investment in Widget Ltd and receives income tax relief thereon such that his net outlay is £100,000 (say subscription price of £125,000, less restricted income tax relief of £25,000). Hamish dies still owning the shares on the second anniversary of the date of issue. At this point, the shares are thought to be worth £125,000.

The shares are left to Agatha, Hamish's widow, and she retains them (trusting in her late husband's judgment about the company's prospects).

Unfortunately, one year after Hamish's death, another company announces a new product which will directly compete with that of Widget Ltd. Not long after, the directors decide that Widget Ltd's future is dire and that it should be liquated. In due course, Agatha receives a total of £10,000 from the liquidator.

Although Agatha has a loss for capital gains tax purposes of £115,000 (probate value less disposal proceeds of £10,000) she is not eligible to make a claim to set this loss against her income under ITA 2007, s 131. Agatha acquired the shares not by subscription, but under the terms of her husbands will.

AGATHA

One half of the £10,000 disposal proceeds of the shares on the liquidation of Widget Ltd will be attributed to the shares obtained by Agatha by way of the lifetime gift from her late husband. The balance is attributed to the shares acquired under the terms of her husband's will.

Here, for the purposes of SLR, Agatha will be regarded, in effect, as the original subscriber in respect of the shares acquired by the lifetime gift from her husband (ITA 2007, s 245(2)). She therefore meets the conditions of ITA 2007, s 131 and can claim SLR on a loss of £45,000 calculated as:

	£
Half of the actual cost of the investment (£125,000)	62,500
Less: half of Hamish's EIS income tax relief (£25,000)	12,500
	50,000
Less: half of the £10,000 disposal proceeds	5,000
Loss relief under ITA 2007, s 131 available against income:	45,000

As regards the shares inherited on her husband's death, SLR relief will not be due (see ***Hamish***). Agatha will simply have the ability to claim a capital gains tax loss as follows:

	£
Half of the £125,000 probate value	62,500
Less: half of the £10,000 proceeds on liquidation	5,000
Loss relief available only against capital gains	57,500

Under the present EIS provisions, the "termination date" is either the third anniversary of the issue of the shares or, if later, the third anniversary of the date the EIS company commenced its qualifying business activity.

Although, on the death of an EIS investor, TCGA 1992, s 62 will operate so as to deem the personal representatives of the deceased (or the executors) to have acquired the EIS shares at a consideration equal to their market value at the date of death, s 62 does not deem the shares to have been disposed of by the deceased on his death. Accordingly, death does not give rise to a disposal for Sch 5B purposes.

Therefore, if none of the trigger events described above occurs before the date of death of the EIS investor, there is no mechanism by which the deferred gain falls to be assessed.

Death of an investor

Not only is death not a trigger event for EIS purposes, but a special provision exists (Sch 5B, para 3(5)) whereby it is declared in effect that an event of the type described in (c) or (d) above, occurring before the termination date (see above), but on or after the date of the investor's death, is to be ignored as regards the tax affairs of the deceased, the estate or, indeed, of any beneficiary who has been lucky enough to have acquired the EIS shares before the event in question.

A similar provision operates as regards the EIS income tax relief (ITA 2007, s 238(1)) where the investor dies before the termination date has been reached in relation to a particular share issue.

Clearly, therefore, the possibility of the investor's death – whether untimely or otherwise – was taken on board by the draftsman of the EIS provisions, but the outcome of the legislation appears to bring about an inequitable, if not a discriminatory, outcome in some situations. Why should the death of one investor in an EIS company result in the promised capital gains tax exemption being withdrawn in effect, while the death of another EIS investor, advised to invest at a time when he was known to be terminally ill, have the effect of bringing about a capital gains tax exemption clearly not intended by parliament?

EIS shares fall in value too

As indicated above, where an EIS investor makes a loss on his investment there is the potential to claim income tax relief on the net loss (after deducting any income tax relief enjoyed by the investor) under the SLR provisions. This reassures many investors, but is it not strange that, as shown in ***Hamish***, the death of the investor results in the effective withdrawal of this relief?

We can contrast the position in ***Hamish*** with the outcome that would have arisen had Hamish made a gift of one-half of the shares to Agatha during his lifetime. The anomalies of the situation soon become clear. In ***Agatha*** it is assumed that the shares held by Hamish on his death (one half of his initial investment) pass to Agatha under her late husband's will. Otherwise, assume the facts are as in ***Hamish*** above.

We can see from these various scenarios that the results are hardly sensible or fair but, when viewed in the context of the tax legislation as whole, there is a logical progression. However, does this take us to the right place? It is difficult for the Treasury to argue against the fact that it is the offer of a substantial tax incentive that will persuade an individual taxpayer – unconnected with a company – to invest in it. So why should the state use the taxpayer's death to renege on its agreement? Withdrawing the promised tax privileges should not sit comfortably with Treasury officials.

Do VCTs show the way?

A venture capital trust (VCT) is a quoted company set up to channel funds from individuals wishing to support new and expanding businesses into qualifying trading companies. VCTs are designed to allow investors to spread their risk. It takes the funds raised from its shareholders and seeks out qualifying companies in which to take a stake. There is a maximum permitted qualifying investment in any one tax year of £200,000, but if the numerous conditions are satisfied, an individual subscribing for shares in a VCT can claim income tax relief of up to £60,000. This relief is withdrawn if the shares in the VCT company are disposed of within five years. As well as the income tax relief on the investment, any dividends received from the VCT are exempt from UK tax.

Any capital gain made on the shares (whether or not they are disposed of within the five-year period) is exempt from capital gains tax. The surprising feature is that this applies not only to the initial share subscriber but also to any subsequent holder of the shares. There are conditions to be met and the subsequent investor must not exceed the permitted maximum in the year of acquisition. But if the company qualifies as a VCT throughout the period of ownership the qualifying shares are an exempt asset for capital gains tax purposes. In addition, the VCT is itself exempt from paying tax on capital gains in relation to investments in qualifying trading companies.

The dividend exemption described above is also extended to subsequent purchasers of the initial subscriber shares, subject to the same conditions being satisfied.

Jerry's Shares is a variant on "scenario 2" in ***Tom's Shares***. The difference is that Jerry subscribed for shares in a VCT which are now being sold by his widow, rather than the EIS shares that were sold by Tom's widow.

Here, unlike Tom's widow in ***Tom's Shares***, no part of the £4.95m capital gain made by Jerry's widow is taxable. In this instance, HM Treasury will honour the promise made to Jerry.

JERRY'S SHARES

Sale by widow of shares in VCT

	£
1 July 2019. Jerry's widow sells shares in VCT plc – proceeds	5,100,000
1 July 2014. VCT shares deemed to be acquired by Jerry's widow at probate value	150,000
Gain	4,950,000

> ***"We can see from these various scenarios that the results are hardly sensible or fair."***

Conclusion

The VCT tax breaks attach to the shares themselves, not the shareholder. But is this not a good example of how the other venture capital schemes should be structured? Indeed, this is already the case where EIS shares are transferred such that TCGA 1992, s 58 (transactions between spouses and civil partners) applies, where the acquiring party will be taxed as though he or she was the initial qualifying subscriber for the EIS shares. Indeed, the acquiring spouse will suffer the clawback assessment where a clawback trigger event occurs on a date after the intra-spouse transfer.

Can it be right that, when the wife of a client phones her tax adviser to explain that she is by her husband's bedside and that he has less than 10 days to live, the first response should be: "Ask him if he is prepared to give you those EIS shares I advised him to buy. And while we are on the subject, I guess he needs to think about those SEIS investments as well. Shame he won't be able to satisfy the two-year ownership test for IHT business property relief."

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