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Finance Acts 2018 and 2019: The New EII Rules

Introduction

Significant changes to the Employment and Investment Incentive (EII) and Start-Up Relief for Entrepreneurs (SURE) were introduced in Finance Act 2018 and further amended in Finance Act 2019 as a result of several factors, including the introduction of the General Block Exemption Regulation (GBER) and the recommendations of the Indecon independent review of the schemes,[1] which focused primarily on administrative changes to improve the efficiency and cost-effectiveness of the scheme and policy measures to increase uptake of the reliefs. This article sets out the main changes to the EII introduced by the last two Finance Acts.

Finance Act 2018

Section 25 of Finance Act 2018 introduced a complete overhaul of how EII relief is claimed. It also aligned our domestic legislation with EU

1 Indecon International Economic Consultants, "Indecon Evaluation of EII and SURE", report for the Minister for Finance (14 September 2018), https://assets.gov.ie/4045/071218130657-3be4a529aeee4999ba8d63bb0c0ff9d9.pdf.

State Aid rules as set out in the GBER. The main changes were:

- There was a move to self-certification by the companies raising EII finance, rather than applying to Revenue for the requisite certificates to be provided to investors to claim the relief. The purpose of this change was to address delays in processing applications, enabling investors to apply for their tax relief earlier.
- Application to Revenue for advance "outline approval" is now restricted to questions relating to the GBER, such as whether an undertaking is a "firm in difficulty" or whether enterprises are linked or partner enterprises within the meaning of the GBER.
- Greater clarity has been given on the ability of companies engaged in R&D to be EII-qualifying companies.
- Certain preferential rights can attach to shares, whereas previously only ordinary share capital qualified for the relief. Note that this extension applies only to the EII and not SURE.
- The Start-up Capital Incentive (SCI) for micro companies was introduced, which relaxes the Finance Act 2017 connected-party rules for family members and connected parties investing in a founder's company. The SCI does not extend to a direct investment by a founder. Instead, they can apply for SURE, a refund of PAYE deducted at source in the previous six tax years, on a personal investment in their company.
- Permitted investments by designated funds were expanded to non-EII investments, and they were no longer limited to being closed funds.
- The relief was extended to 31 December 2021.

The GBER and the New EII Legislation

The new legislation integrates the EU State Aid GBER rules[2] into TCA 1997. A RICT[3] group is defined as the company raising the EIIS/SURE/SCI funds together with its linked enterprises and partner enterprises. The significance of this is that not only the fundraising company but also its linked and partner enterprises need to be examined to determine whether a funding round qualifies for the EII. This can be an onerous task where the connections between enterprises, which can include sole trader and partnership structures, are not entirely obvious and the companies are not in a formal group relationship.

It is especially complex where connections have to be traced through natural persons (human beings). An individual might have a tenuous connection to another company that at first glance is not in a group, but with further investigation it might be found that it is a supplier or customer – "upstream or downstream", to use GBER language – of the EII company.

Being in a RICT group has the following significance for EII purposes:

- The RICT group as a whole must be an SME on the date on which the eligible shares are issued. If there is an entity in the RICT group that is a large entity, it might result in the claimant company not being a qualifying company for EII purposes.
- No company in the RICT group can be listed or plan to float at the date on which the EII shares are issued.
- Under the Deggendorf Principle, no entity in the RICT group can be the subject of an outstanding European Commission recovery order at the date on which the EII shares are issued.

2 Commission Regulation (EU) No. 651/2014 of 17 June 2014, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02014R0651-20170710&from=EN.

3 Relief for investment in corporate trades.

- An EII investment is an "initial risk finance investment" only if it takes place within seven years of the RICT group's first commercial sale. If there is a long-established entity in the RICT group, this may prohibit the raising of EII-qualifying funds unless the company can satisfy the conditions of the round being "expansion risk finance" or "follow-on risk finance", to which different rules apply.
- Throughout the relevant period, being the four years after the date on which the shares are issued, no entity in the RICT group can have any amount not paid up on its issued share capital.
- Under the old EII rules, a receipt of value such as a redemption of an investor's shares by the EII company would result in a clawback of the relief. Under the new system, a receipt of capital in such circumstances from any entity in the RICT group will trigger the clawback.
- EII relief is not available to an individual who is connected with the EII company. An individual is deemed to be connected with an EII company if he or she or an associate is a partner, director or employee of the EII company or any company in the RICT group or has an interest in the capital of the EII company or any company in the RICT group.

Technical amendments to definitions and other aspects of the relief included:

- The definition of "professional services", which are not qualifying trades for EII purposes, was aligned with the new definition set out in the KEEP legislation (s128F TCA 1997), whereas the previous definition had been based on the legislation on the close company surcharge for professional services. The definition does not list "engineering" as a professional service, recognising the importance of high-tech companies that require early-stage finance to execute their business plans.
- Under the pre-Finance Act 2018 legislation, there were several definitions of the "relevant period", depending on the context in which it was used. From 1 January 2019 there is only one much simpler definition, being the period beginning on the date on which the shares were issued and ending four years after that date.

Qualifying Investments after Finance Act 2018

For an investment to qualify for EII relief in respect of shares issued on or after 1 January 2019 it needs to be a "relevant investment" for "eligible shares" by a "qualifying investor" in a "qualifying company".

Eligible shares

Eligible shares are newly issued shares. Unlike under older versions of the EII and its predecessor, eligible shares can have preferential rights to dividends and on a winding-up. They can also be redeemable. This applies only for the EII and SCI but not SURE, which still requires shares to be ordinary shares to qualify for relief on a founder's investment.

Qualifying company

Several of the old EII criteria have been carried into the new EII regime. Some new conditions of note are:

- The EII company must have a tax clearance certificate on the date on which the eligible shares are issued.
- The EII company must be GBER-compliant.
- As outlined above, a company can no longer apply to Revenue for advance outline approval certifying that it is a qualifying company and Revenue will only give advance opinions that relate to the GBER rules. Qualifying investment

From the company's perspective, a qualifying investment must involve the subscription for eligible shares by an individual; the amount received must be used wholly or mainly for a qualifying purpose within the relevant period; and the investment must be based on a business plan, as defined by the GBER. The funds can also be used to subscribe for new shares in a qualifying subsidiary. The finance must be initial risk finance, expansion risk finance or follow-on risk finance, as defined in the GBER and ss493 and 496 TCA 1997. The maximum risk finance that a company can raise in a 12-month period is €5m, with a lifetime limit of €15m. Section 497 of TCA 1997 sets out the formulae to calculate the amount of finance that is not a qualifying investment if those limits are breached. Finance Act 2019 provided for a technical amendment to the formulae.

Qualifying investors and connected-party rules

The scheme still prevents persons connected with the EII company from claiming EII relief if an investment under the SCI is not possible. The broadly drafted definition of connected parties – specifically, where a person or his or her associate has any interest in the share capital, loan capital or voting power of the company, or rights to assets on a winding-up of the company – can result in a first-time investment or follow-on investment by an investor not qualifying for the relief if he or she or an associate already owns or owned non-EII shares in the company or another company in the RICT group in the period two years before and four years after the subscription for EII shares. If there are any arrangements to secure the result that a person is not connected with the company by someone else investing on his or her behalf, the first person will still be deemed connected and will not qualify for the relief. Examples of where this can apply in practice are given below.

Example 1

John and Mary are married. In 2017 John subscribed for preference shares in Cuppatee Limited at a time when only ordinary shares qualified for EII relief. The company raised a second round of funding in 2019, giving existing investors the opportunity to follow their money in accordance with pre-emption rights set out in the shareholders' agreement, in addition to raising funds from new investors and Enterprise Ireland. Investors were given the opportunity to subscribe for the same class of preference shares as they did in the first round. Because John's 2017 investment could not qualify for EII relief and he owns shares in the company, the 2019 investment cannot qualify for EII relief. Furthermore, should his wife Mary decide to invest in 2019, she also cannot qualify for EII relief because her spouse, being an associate, has shares in the company that did not qualify for EII relief at the time of acquisition.

Example 2

One of the 2019 new investors in Cuppatee Limited was Sophia, who has significant experience in the company's sector. A year after raising the funds, the company offered Sophia the role of COO; her remuneration package included eligibility to participate in the company's employee share option scheme. Section 500(5)(a) of TCA 1997 provides that "an individual shall have an interest in the capital of a company in a RICT Group if that individual, or that individual's associate, directly or indirectly possesses **or is entitled to acquire**...any of the issued share capital of any such company [emphasis added]". Sub-section (7) states that "an individual shall be treated as entitled to acquire anything which he or she is entitled to acquire at a future date or will at a future date be entitled to acquire, and there shall be attributed to any person any rights or powers of any other person who is an associate of that person". An individual cannot be a qualifying investor if he or she become connected with the company at any time within the compliance period (being two years before and four years after the shares are issued).

As a result, the EII relief that Sophia would have claimed on her 2019 investment will be clawed back under s508V(1)(b)(v) TCA 1997 because she ceases to be a qualifying investor. A Finance Act 2019 technical amendment provides that interest on an underpayment of tax arising from the withdrawal of the relief will apply from the date that she ceases to be a qualifying investor.

Start-up Capital Incentive

The connected-party rules for the SCI introduced on 2 November 2017 have been relaxed for investments by associates of founders but not founders themselves, where the total lifetime risk finance raised is less than €500,000 and the company is a micro enterprise within the meaning of the GBER, is carrying on a qualifying new venture, has no partner or linked enterprises, and has not started to trade more than seven years before the shares are issued. This gives a potential lifeline to companies during the critical early days, when potentially the only source of finance is sympathetic friends and family.

Designated Funds

Finance Act 2018

With effect from 1 January 2019, designated funds no longer need to be "closed" funds, nor do they need to invest exclusively in EII-qualifying companies to be EII-compliant investments. Under Finance Act 2018, investors could elect to claim the relief in either the year of subscription to a closed fund or a later year in which the fund invested the money in individual companies.

Finance Act 2019

Section 26 of Finance Act 2019 amended s508J TCA 1997 with effect from 1 January 2020 to provide that where investors make their EII-qualifying investment through a designated fund, relief will be given in the year of subscription to the fund. There will no longer be a choice for the investor to claim it in either the year of subscription or the year in which the shares are issued to the fund by the EII investee company, if later. The "relevant period" for such a company will still start on the date on which the shares are issued rather than the earlier date on which the investor subscribed to the fund. This will be important in terms of working out the timing of and return on investment for such investors.

An administrative change for designated funds was also introduced by Finance Act 2019. Designated funds are required to report to Revenue certain details of investments made and statements of qualification received from qualifying companies in which they invested in a year of assessment. Finance Act 2018 provided that such reports should be sent to Revenue by 30 June of the following year. Finance Act 2019 has changed this by requiring the fund to submit the report within 30 days of receiving a statement of qualification from a qualifying company.

Self-Certification Rules

The most fundamental change to the scheme was moving responsibility for certifying the relief from Revenue to the investee companies that are raising funds. The aim is that this will enable investors to receive their certificates and claim the relief much earlier. It should also free up Revenue resources and reduce the significant amount of administration associated with processing applications.

As regards issuing certs for stage 1, or the 30/40ths relief for the year of investment, the company cannot do so until it has spent at least 30% of the funds raised on a qualifying purpose, which is the use of the funds by the EII company or a qualifying subsidiary for qualifying trading purposes, including R&D and innovation undertaken before the company commences to trade, provided that the money will directly contribute to the creation or maintenance of employment. This is welcome clarity on the eligibility of R&D-related spend and when it can be claimed.

The company issues the certs directly to the individual investors, SURE investor or designated fund manager, as the case may be. They cannot be issued more than two years after the date on which the shares are issued.

For shares issued up to 8 October 2019, relief is given in two stages. Statements of qualification (second-stage relief) must be issued by the company not earlier than the end of the four-year relevant period and not later than two years after the end of the year of assessment in which the employment increase milestones are achieved (i.e. year 3). For example, if a company issued shares on 1 June 2019, it cannot issue the first 30/40ths statement of qualification before 30% of the funds are spent, nor can it issue it after 31 May 2021. It must increase employee headcount and wages by at least one extra employee on or before 31 May 2022 for second stage relief. It cannot issue the statement of qualification (second-stage relief) before 1 June 2023 or after 31 May 2024.

EII investors will welcome the new self-certification procedure as they will receive their certs faster with limited risk of clawback. However, issuing an incorrect statement of qualification will result in a clawback of the relief payable by the company, together with interest and penalties of up to 100% of the relief claimed. There are therefore very serious potential implications of getting any aspect of them wrong. For example, if the cert states that 30% of the funds were spent on a qualifying purpose by a particular date and on a future Revenue inspection it is found that only 29% of the funds were so spent, then it could result in a withdrawal of the relief, which would have to be funded from the company's own resources. This could have an impact on non-EII stakeholders and shareholders, who may not agree to their investment funds being used effectively to pay other investors' tax relief rather than to execute the company's business plan.

Meaning of spend on qualifying purpose

The company must intend to use the funds raised on a qualifying purpose within four years of the shares being issued. If the funds are only partially spent on a qualifying purpose, then only a proportionate amount of the relief will be given. To maximise the relief, if the company has other, non-EII sources of funds, it should allocate them to non-qualifying purpose spend.

In Tax and Duty Manual Part 16-00-02 Revenue has stated that in determining spend on a qualifying purpose, normal accounting principles will be applied. For example, if EII funds have been raised for specific future expenditure such as capital investment in plant and machinery and the company has contractually committed to incurring that spend, it will be treated as incurred when actually incurred or on the date it was committed. In addition, the expenditure should be tax-deductible under normal tax principles to be included as spend on a qualifying purpose.

Clawback Triggers

The clawback provisions tend to impose a tax charge on the person in control of the information or process that has not been complied with.

Company

The following will trigger a clawback of the relief from the company:

- An incorrect statement of qualification is issued.
- The company ceases to be a qualifying company within the relevant period.
- The investment ceases or partially ceases to be a qualifying investment within the relevant period.
- Persons other than EII investors receive value from any company in the RICT group during the relevant period. There is a "capital redemption window" whereby a clawback will not be triggered if the EII company (but not another RICT group company) redeems or repurchases its share capital from non-EII members if this occurs more than 18 months after the last time that the RICT group raised EII/SURE/SCI funding and the RICT group does not raise EII/SURE/SCI funding in the following 12-month period.

The relief is clawed back by the raising of an assessment under Schedule D, Case IV, on the company. For first-stage relief to be clawed back, the amount on which relief was given is multiplied by 1.2 and then subject to 25% corporation tax. Second-stage relief is clawed back by multiplying the relieved amount by 0.4 and then subjecting it to 25% corporation tax. The close company surcharge on investment income does not apply.

Statements of qualification have tax return status. Penalties for deliberately or carelessly making an incorrect return can apply additionally on a clawback. They can be up to 100% of the tax arising.

Investor

These events will trigger a clawback of tax relief from the investor:

- The relief is found not to be due in circumstances other than those that trigger a clawback from the company.
- The company takes over a trade or company in which the individual investor was previously involved (replacement capital).
- The shares are disposed of within the relevant period or the investor enters into an option agreement within the compliance period for the disposal of his or her shares other than at market value.
- The investor ceases to be a qualifying investor within the relevant period; for example, he or she is, or becomes, connected with the company.
- Raising the funds is part of a tax-avoidance scheme.
- A qualifying subsidiary is disposed of (including on a winding-up or dissolution) within the relevant period, the EII funds had been raised for the purposes of investing in that subsidiary and the proceeds of the disposal are not returned to qualifying investors without undue delay. The actual return of funds within the relevant period will also trigger a partial clawback.
- The investor receives value from the company during the compliance period.
- There are arrangements that substantially reduce the investor's risk. Under the old EII rules, there could be no arrangements to eliminate the risk associated with an EII investment. Under the new rules, the legislation states that there can be no arrangements, agreements or understandings to substantially reduce the risk for an investor, which is a much lower bar. Examples of such arrangements and agreements would be provisions set out in the company's constitution or shareholders' agreement, together with arrangements between members of the RICT group either to acquire the EII shares or to protect the EII company's asset values.

  In terms of commercial arrangements often seen in the context of older EII structures, Revenue's Tax and Duty Manual Part 16-00-03, para. 2.1, states that "if there was a put/call option with the founder shareholders for the disposal of the shares after 4 years, then the shares would not be eligible shares. In contrast, the shares can be convertible into ordinary shares in the event they are not redeemed, provided that the terms of the conversion are reasonable."

Filing obligations for nominees

Section 494(2) of TCA 1997 places a statutory obligation on nominees to comply with reporting requirements under ss892 and 894 TCA 1997 where they hold shares on behalf of EII-qualifying investors. The shares will not be eligible shares for EII purposes unless those reporting obligations are met. If a share is not an eligible share, then it is not a qualifying investment under s496 TCA 1997 (company perspective), nor is the investor a qualifying investor. Any statement of qualification issued by the company in respect of those shares would be incorrect, which would result in a clawback of tax relief, as would ceasing to be a qualifying investor during the relevant period. Interest on an underpayment of tax tends to run from the date of the event that triggered the clawback.

Finance Act 2019

When Finance Bill 2018 was published, the Minister for Finance stated that the changes to take effect from 1 January 2019 would be a first step towards improving the relief, dealing with the more immediate shortcomings of the scheme. He stated his intention to continue to improve the relief in future Finance Acts. Section 26 of Finance Act 2019 introduced the following welcome measures in this context:

- Full relief of 40% can be claimed on a subscription for eligible shares on or after 9 October 2019. For shares issued up to

8 October 2019, the relief must be claimed in two stages – 30/40ths in the year of investment and the balance of 10/40ths four years later if certain employment milestones are achieved by the company by the end of year 3.

- For investments made on or after 1 January 2020, the annual maximum investment on which an individual can claim EII relief has increased from €150,000 to €250,000.
- From 1 January 2020, a maximum investment of €500,000 can qualify for the relief in any one tax year if the investor retains the shares for a period of seven years. There is no provision for a partial clawback in respect of shares disposed of between years 5 and 7 for the first €250,000 of an individual's investment. A clawback arising as a result of someone other than the qualifying investor receiving value from the company will occur only where that value is received within the first four years of the holding period.

Finance Act 2019 also contained some technical tidying-up measures to improve the operation of the relief, along with provision for penalties in the event that certain persons become aware of a clawback event and do not notify Revenue within 60 days of becoming so aware.

Revenue Guidance

The reader is encouraged to consult Revenue's Tax and Duty Manuals.[4] They deal with the pre- and post-Finance Act 2018 EII and SURE rules and provide practical examples of the operation of the relief, in particular, the application of the GBER. At the time of writing, it is understood that Revenue is updating the manuals to reflect the changes introduced by Finance Act 2019, as well as practical experience of the new rules since they came into operation in January 2019.

Impact on Investors, Companies and Revenue

Investors should receive their certificates and tax relief much earlier than under the previous scheme. They cannot apply for the relief until they have received their statements of qualification from the investee companies.

The cost of finance and associated administration will increase for companies. They are also taking on higher risk than previously by being responsible for paying back the tax relief in most clawback scenarios.

Revenue resources should be more efficiently and cost-effectively employed now that they no longer have to process applications. The EII will be examined as part of Revenue's normal intervention process instead.

Conclusion

The changes to improve the certification process and reduce administration are certainly most welcome, together with the Finance Act 2019 increases to the individual limits on investment, reflecting the recommendations of both the Indecon report and the Irish Tax Institute. It is anticipated that further improvements will be made to the scheme to achieve its objective of being a viable alternative source of finance for SMEs and early-stage start-ups.

Meeting the GBER criteria continues to be the most significant barrier to companies successfully qualifying for EII funding. Other enhancements would be welcome in forthcoming Finance Bills, such as a more proportionate punishment for relatively minor indiscretions or administrative errors.

Read more on taxfind From Irish Tax Institute *Direct Tax Acts, Finance Act 2019; Finance Act 2019 - The Professional's Guide*

4 For the post-Finance Act 2018 rules, see "Relief for Investment in Corporate Trades: As It Applies to Companies", https://www.revenue.ie/en/tax-professionals/tdm/income-tax-capital-gains-tax-corporation-tax/part-16/16-00-02.pdf, and "Relief for Investment in Corporate Trades: As It Applies to Investors", https://www.revenue.ie/en/tax-professionals/tdm/income-tax-capital-gains-tax-corporation-tax/part-16/16-00-03.pdf. For pre-Finance Act 2018 EII and SURE investment guidance, see "The Employment and Investment Incentive (EII) Relief for Investment in Corporate Trades", https://www.revenue.ie/en/tax-professionals/tdm/income-tax-capital-gains-tax-corporation-tax/part-16/16-00-10.pdf, and "Start-Up Refunds for Entrepreneurs (SURE)", https://www.revenue.ie/en/tax-professionals/tdm/income-tax-capital-gains-tax-corporation-tax/part-16/16-00-11.pdf.