SENECA PARTNERS

Guide to Loss Relief

Introduction

The Enterprise Investment Scheme ("EIS") was introduced in 1994, as a way of encouraging investment into smaller unquoted companies ("SMEs") carrying on a qualifying trade. Small and medium-sized enterprises (SMEs) represent over 99% of all private sector businesses in the UK, employing 16.6 million people (60% of the private sector workforce) and generating £2.2 trillion of turnover.*

SMEs therefore have an important role to play in driving growth in the UK economy, opening new markets and creating jobs. However, investing in SMEs is high risk, with the returns seen from different companies varying significantly. Unfortunately, whilst some companies may do well, others may fall in value or fail.

As there is a high risk of capital loss, the Enterprise Investment Scheme offers investors a number of different tax reliefs as a counter to those risks. One of these is Loss Relief.

Loss relief

If you sell EIS qualifying shares at a loss, Loss Relief is available to you against Income Tax or Capital Gains Tax due or paid, depending upon which is most appropriate for you.

You can only claim Loss Relief when the net sale proceeds are less than the purchase cost, net of any Income Tax relief you have received.

So, for example, if you subscribed for EIS qualifying shares for £10,000 and have received £3,000 in Income Tax Relief on their acquisition, the net cost of the shares is £7,000.

If you sold the shares for £5,000 after the termination date of these shares (3 years from the later of the date of investment or the date the company started trading), you can therefore only claim Loss Relief on the net loss of £2,000.

As Loss Relief is given as a relief given against taxable income or gains, it will only offset some of the loss made.

*Source: "Business Population Estimates for the UK and the Regions 2019" Statistical Release, published by the Department for Business, Energy, & Industrial Strategy on 10th October 2019.

Claiming loss relief against Income Tax

If you make a loss in this Tax Year, you may be able to offset a loss against your income tax bill for this Tax Year or last Tax Year or both if the loss is big enough. You would only claim Loss Relief against Income Tax if you have sufficient income subject to Income Tax.

You are generally entitled to a personal allowance (i.e. an amount of income on which you are charged no Income Tax) and for most people this is currently £12,500 p.a. If that is the case and your income is less than £12,500 in a Tax Year, there is no point in making such a claim.

In the 2020/21 Tax Year, the following rates of Income Tax broadly apply:

- The first £12,500 of income is taxed at 0%, assuming your Personal Allowance is £12,500. In addition, the first £2,000 of dividends you receive will not be subject to tax.
- The next £37,500 of income is charged at 20% ('basic rate tax'). In addition, you will pay 7.5% on any dividends above the £2,000 allowance.
- The next £100,000 of income is charged at 40% ('higher rate tax'). In addition, you will pay 32.5% on any dividends above the £2,000 allowance.
- Any further income is charged at 45% ('additional rate tax'). In addition, you will pay 38.1% on any dividends above the £2,000 allowance.

In addition, your personal allowance is reduced by 50% of your income above £100,000. For example, if your income is £120,000 your personal allowances would be £2,500 rather than £12,500. This therefore gives rise to a higher marginal income tax charge which is not considered in this document.

Loss Relief is claimed at your marginal rate of Income Tax, in other words the loss is used to reduce the amount of income on which Income Tax is paid.

So, if we assume that you have made a £2,000 loss and are entitled to the standard personal allowance of £12,500:

1. If your income is £12,500 or below, you would not be able to claim Loss Relief against Income Tax as you have not paid any Income Tax.
2. If your income is between £14,500 and £50,000 your Loss Relief would reduce the amount on which you pay basic rate Income Tax by £2,000 in that Tax Year, reducing the amount of Income Tax you pay by £400 (being 20% of £2,000). You have therefore received Loss Relief at a rate of 20%.
3. If your income is between £52,000 and £150,000 your Loss Relief would reduce the amount on which you pay higher rate Income Tax by £2,000 in that Tax Year, reducing the amount of Income Tax you pay by £800 (being 40% of £2,000). You have therefore received Loss Relief at a rate of 40%.
4. If your income is £152,000 or more your Loss Relief would reduce the amount on which you

pay additional rate Income Tax by £2,000 in that Tax Year, reducing the amount of Income Tax you pay by £900 (being 45% of £2,000). You have therefore received Loss Relief at a rate of 45%.

Where your income falls between the examples shown above, the calculation of the effect of Loss Relief is a little more involved. This is due to some of the £2,000 loss falling in one tax band with the remainder falling into another. In other words:

5. If your income is between £12,500 and £14,500 your Loss Relief would effectively mean you need not pay any Income Tax in that Tax Year. For example, for an income of £13,500 where you would normally pay £200 Income Tax (being 20% of *[£13,500 - £12,500 =]* £1,000), meaning that you have effectively received Loss Relief at a rate of 10% (i.e. the £200 reduction in tax divided by the £2,000 loss).
6. If your income is between £50,000 and £52,000 some of your Loss Relief would offset the higher rate tax you pay with the remainder offsetting basic rate tax. For example, for an income of £51,500 where you would normally pay higher rate tax on £1,500 (being £51,500 *[your income]* - £37,500 *[basic rate band]* - £12,500 *[personal allowance]*), the amount of Income Tax you pay would be reduced by £700 (being [40% of £1,500] + [20% of £500]), giving your Loss Relief an effective rate of 35% (i.e. £700 tax saved divided by the £2,000 loss).
7. In the same way, if your income is between £150,000 and £152,000 some of your Loss Relief would offset the additional rate tax you pay with the remainder offsetting higher rate tax. For example, for an income of £151,500 where you would normally pay additional rate tax on £1,500, the amount of Income Tax you pay would be reduced by £875 (being [45% of £1,500] + [40% of £500]), giving your Loss Relief an effective rate of 43.75% (i.e. £875 tax saved divided by the £2,000 loss).

The above assumes that your income does not include any dividends. If it does then the tax relief may be lower due to the lower rate of tax that is applicable to dividends.

Claiming loss relief against Capital Gains Tax

It is usually more advantageous to claim loss relief against Income Tax as the rate of Income Tax is generally higher than that for Capital Gains Tax ("CGT") regardless of whether you are a basic, higher or additional rate taxpayer (albeit certain gains are taxed at 28% rather than 20% or 10%). This, of course, assumes that there is sufficient Income Tax against which you can obtain relief.

That being said, there can be circumstances where the potential Capital Gains Tax relief exceeds the amount of Income Tax relief that is available to you and if that is the case, it may be more beneficial to claim loss relief against CGT. As with Income Tax, the net loss is used to reduce the total value of the gain made and thus the amount of CGT due. However, in this case, the capital loss arising cannot generally be carried back to the previous tax year.

If you believe this applies to you, you should seek guidance from a tax adviser.

Loss relief within a portfolio

You may have invested in an EIS portfolio service, where the manager of that service has invested in a number of different companies on your behalf.

For tax purposes, each company within your portfolio is considered to be a separate investment.

So, for example, a portfolio containing holdings in five EIS qualifying companies is viewed as five separate investments for tax purposes. If you make a net loss when your holding in one of the companies is sold, it does not matter how any of the other four companies has performed. You may therefore be able to claim loss relief even if the other four investments have generated a positive return.

How to claim loss relief

If you complete a paper self-assessment tax return, any net losses can be claimed by completing HMRC's SA108 form (capital gains summary), regardless of whether the claim is against Income Tax or CGT.

If the result of including the net loss is that you have already paid too much tax for the Tax Year for which you are claiming, you can request that HMRC repay the excess either by cheque or directly into your bank account, by completing the relevant part of the self-assessment form.

You can download a self-assessment form from hmrc.gov.uk or ask HMRC to send you one. HMRC have also produced guidance notes to help you fill out the SA108 form.

Alternatively, if you complete your self-assessment tax return online, there are notes throughout the process to help you complete any claim.

We are not able to provide tax advice and would recommend that you speak to your tax adviser.

When to claim loss relief

HMRC will only consider a claim for loss relief once one of three events has occurred:

1. Your shares have been sold, resulting in a net loss
2. A company in which you are invested has been dissolved without the shares being sold
3. A company in which you are still invested no longer has any value (a "negligible value claim")

Whilst the first two are easy to demonstrate, a negligible value claim needs to be supported by evidence that HMRC will accept. One example might be where a company has gone into administration and the administrator has confirmed that "there are no assets available to repay unsecured creditors" (and thus none available to repay shareholders, who rank lower than the company's creditors when considering who should be repaid).

An investment manager taking the view that an investment currently has no value is unlikely to be sufficient, unless based on something substantive such as the example given.

Your financial or tax adviser should be able to give you more details.

Loss relief on inherited shares

It is not possible to claim Income Tax loss relief on shares that you have inherited, even if they were previously EIS qualifying. However, you may be able to claim a capital loss on such shares if they have fallen in value since you inherited them. HMRC treats inherited shares as if they have been acquired by the deceased's personal representatives at their market value at the time of death and therefore as "secondary" (i.e. previously owned) shares. Only the person who bought the shares when they were first issued can potentially benefit from EIS tax reliefs. Again, your financial or tax adviser should be able to give you more details.

Tax rules and their treatment may change

The rules surrounding loss relief and EIS tax reliefs in general may change in the future, as may the way in which HMRC administers and interprets those rules. In addition, any changes to your own personal circumstances may have an effect. You should also bear in mind that tax reliefs depend on the companies in which you are invested maintaining their EIS qualifying status.

Please Note

This document was published in August 2020 and therefore may not be current. The information provided in this guide is based on our understanding of current legislation and is for illustrative purposes only. We do not offer investment or tax advice and accept no liability should you suffer any loss as a result of relying on the information contained in this guide. We recommend that you contact HMRC directly if you are unsure of your tax liabilities or require further information on your personal tax circumstances.

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Authorised and Regulated by the Financial Conduct Authority
Guide to Loss Relief Version 1 August 2020