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RAISING FUNDS FOR BUSINESS PURPOSES

Loan Finance

The majority of small trading businesses fund themselves from bank lending and retained funds. Loan finance can extend from short term finance, typically provided by a bank, to longer term finance provided by investors. In the case of longer term finance and funding, the investor may acquire an interest in the business.

A loan or investment, whether from family friends or outsiders, should be formalised in a legal agreement. The legal agreement should provide for the nature and timing of the return of the money, how much is paid and whether the investor can expect to receive profits or shares in the business. A repayment schedule should be provided for.

If the loan agreement is to cover a longer term investment, the investor may wish to have a greater say in the business. The investor may want a say in certain key business decisions such as the taking on of additional liability. The loan agreement should also deal with various scenarios which can arise.

Interest bearing loans have tax implications for the borrower and lender. Generally interest must be deducted on loans paid other than to banks. The lender must declare interest received as taxable interest.

Tax Aspects of Finance

There are a number of methods of borrowing money or financing in a tax efficient way in the UK. Leasing or renting an asset can be efficient, as the cost is tax deductible. The write off of the purchase price of assets against tax is only allowed where the assets qualify for capital allowances. The write off is over a period of time, rather than up front in the year of purchase, when the actual expenditure may have been incurred. See our separate guides in relation to Capital Allowances.

Where borrowing is undertaken to acquire a capital asset, interest but not the capital repayments may be deducted in the income tax computation. Deduction will generally be allowed for repairs and maintenance.

Interest paid on loans taken out by businesses are usually deductable expenses when computing tax. The loans must be exclusively for a business purpose. Interest on overdrafts and credit cards may be deductible if they are used for business purposes.

As in Ireland, it is possible for an individual to obtain a tax deduction against income tax for interest paid on a “qualifying loan”. A "qualifying loan" is one used to buy shares in a company or a stake in a business in which the individual holds 5% shareholding, to buy shares in a limited company for which the individual works or to buy shares or lend money for business purposes to a partnership. The company must be under the control of less than five people and the lender must not be connected to the company,

The Enterprise Investment Scheme applies to trading companies, but not service or investment companies. This allows individuals who invest in shares, to get tax relief at the lower rate of income tax. They can defer capital gains tax on their gains. Certain conditions must be met and the company must be a "qualifying company". Interest on loans taken for the purpose of investing in qualifying companies is not tax deductible.

Equity and Venture Capital

Equity finance is share capital invested in a business for the medium to long term in return for a share of the ownership or share capital. Equity investors share the risks of the business and will require a corresponding reward.

Business "Angels" are typically wealthy individuals who invest in businesses in return for equity. Some invest on their own or as part of a network or club.

Venture capital is also known as "private equity". A venture capitalist will look to invest large sums of money in return for a share of the business. Minimum investment tends to

be around £2,000,0000. A business plan is required. Significant earning potential with a high return investment in a specific time frame is usually a requirement.

The VC will vet the business plan, the management expertise and other aspects of the business. The process can be long and complex. A detailed business plan and legal agreement will be required. The venture capitalist will generally require an exit mechanism after a period of five to seven years.

The UK Government has established enterprise capital funds which are commercial funds with a mix of private and public money. There are regional venture capitalist funds aimed at providing risk capital of up to £500,000.

Where an investment takes place, a number of key contracts will be put in place. Generally, the venture capitalist will require various categories of shares in the business, giving preferential return and possibly giving rights to convert to greater share holdings. Management may be incentivised by obtaining increased shareholding where certain success criteria are met. See our separate note in relation to Venture Capital.

This Guide is intended as an overview and broad outline of the matters covered in it. Its purpose is to inform and raise awareness. We are happy to offer specific legal advice on particular circumstances.

This Guide should not be relied on as a substitute for comprehensive legal advice with reference to the particular circumstances.

While we have taken due care in the preparation of this publication, we do not accept legal liability as a result of any reliance placed on anything in this Guide. The reader should rely only on specific legal or taxation advice.

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