



Entrepreneurs' relief and enterprise investment schemes

The U-turn the government made when it introduced Entrepreneurs' Relief (ER) was well covered at the time. The move to 18% flat rate Capital Gains Tax (CGT) was seen as a major blow to owners of family businesses as well as private equity fat cats. This is because these groups rarely paid the headline 40% CGT, as they benefited from business asset taper relief that reduced the effective rate to 10%. Therefore the change almost doubled the CGT payable.

The response in the form of ER was to allow entrepreneurs a tax break on the first £1m of gains made: in fact just over half the gain (5/9) is taxed, and the remainder treated as a tax-free gain. The effect of this concession is to reduce the effective rate of tax they pay on the first £1m from 18% to 10%. So much for the background to ER. Let's now bring Enterprise Investment Schemes (EIS) into the picture.

Mr Smith sells his shop for a profit of £900,000

An EIS is mainly used by individuals who have realised a capital gain and would like to defer (perhaps indefinitely to take advantage of uplift on death) the CGT that is payable on that gain. Pre-April 2008 this is how it would work:

Mr Smith bought a corner shop for £100k and a few years later, in March 2008, sold it for £1m. He had a gain of £900k on which he had to pay CGT of £90k (10% effective rate – after full business asset taper relief). He could simply have paid the tax out of the proceeds and walked away with £910k in cash.

Lack of access deterred some

Alternatively Mr Smith could have invested in an EIS rather than paying across the CGT. But in order to do so he would have had to invest the whole (pre-taper) gain in EIS ie £900k. While he would have avoided paying CGT, he would have been tying up £900k indefinitely. Having sold his business for £1m he would only have £100k cash in his pocket (perhaps less if he had borrowed to buy the corner shop in the first place and had to settle the loan out of the proceeds). This obligation to 'lock up' funds has in the past meant that many people in Mr Smith's position

have not bothered with an EIS investment and simply paid across the CGT.

Is it different with entrepreneurs' relief?

Mr Jones has a similar corner shop that he bought for £100k. In June 2008 he sells it for £1m. He has a gain of £900k but as he is eligible for ER the taxable gain is reduced to £500k, on which he will pay CGT at the new flat rate of 18%. His tax bill would therefore be £90k.

So the end result looks no different – well done Gordon. But there is a difference, because ER in relation to EIS works in a very different way to the old taper relief, which was abandoned when the new flat rate CGT was introduced. The fundamental distinction is that EIS participants can now invest just a post-ER gain rather than a pre-taper gain, which reduces their tax liability considerably.

Now more attractive to people selling businesses

Returning to our example, if Mr Jones wanted to defer the CGT bill, he only has to make an investment into the EIS of the gain after the ER reduction – £500k. This will leave him with £500k in cash from the proceeds to do whatever he likes with. This is a much more attractive position to be in. Ultimately the new ER relief makes EIS investments much more attractive to the many people crystallising gains from selling small businesses.

The above example has focused only on the CGT deferral that EIS brings. But there are also benefits in the form of income and inheritance tax reductions. Mr Jones would get £100k (20% of the invested amount) knocked off his income tax bill for the year of investment. If he were to die while still holding the investment he would never pay the deferred CGT (£90k). And if he had held the investment for two years at time of death, the whole investment would be outside his estate, saving another £200k in inheritance tax. All in all, a potential tax saving total of £390k from an investment of £500k – not too bad.

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What about earlier gains?

With some careful planning, it's those tax benefits which can be fully exploited, whatever the timing of gains and investments. Returning again to the example, what happens if the gain was crystallised before 6 April 2008, meaning ER is not relevant?

Well, with a two stage planning approach Mr Smith could still benefit from the reduced amount of investment required. He could invest in an EIS under the old rules (putting in £900k) and defer the gain. He could then sell his EIS investment, which will revive the gain, but only after 6 April 2008. This revived gain is now in a tax year when ER can be used. So he can now invest part of the proceeds from the sale of the first EIS into a second EIS, but can defer the whole CGT bill by investing only £500k – just like Mr Jones. In fact, if Mr Smith was willing to hold onto his first EIS investment for three years before swapping into the second one, he would get a £100k income tax rebate for a second time.

It is also possible that Mr Smith could benefit even more. If he had only owned his corner shop for say, 18 months, his original tax bill would have been at an effective rate of 20% due to the 50% business asset taper relief. By moving the gain from the taper relief regime into the ER regime, he will have reduced his effective rate to 10%, a saving of £90k. There are even circumstances where the original gain would not have attracted any taper relief, but could benefit from ER, creating a saving through EIS deferral of 30%. However these are likely to be less common. Overall, it is well worth reviewing any gains made in the last three years to see if a move into the ER regime makes sense.

However, is EIS suitable? For many individuals like Mr Smith and Mr Jones, who have themselves been entrepreneurs, a traditional portfolio of EIS investments will have the appropriate risk/return profile. However, it is important to choose an investment managed by a team with a strong track record in early stage companies

Lower risk, predictable returns and liquidity

However, not every entrepreneur is comfortable having their money invested in early stage companies, even by a very experienced venture team. Investment companies have therefore sought to respond accordingly. A new type of EIS, offering lower risks, predictable returns and even liquidity have recently been launched. Not the characteristics that you traditionally expect of an EIS.

Innovations such as this have been well received by risk-averse investors seeking an EIS investment with as little downside risk as possible, a non-controversial trade and an exit after three years at a price equal to net asset value. Inevitably, the upside potential of such investments is limited but, given the large tax-breaks, they are attractive to risk-averse investors.

It is clear that, if you have a client who has made a gain from sale of a business, it is advisable to have a look at the opportunities presented by EIS in combination with ER. This stands even if the gain occurred before the introduction of ER. You can defer (or reclaim) CGT with an EIS investment that is significantly lower than previously because of the introduction of ER. For qualifying investors, the potential tax benefits make for a very attractive investment vehicle. While it may not have been Gordon's intention, we should thank him none the less, by making sure as many people as possible reduce their tax bills through combining ER with risk appropriate EIS investments.

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