

Article topic: Financial Management

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Enterprising Investments

Enterprise Zone Investments offer significant tax deductions upfront which can be tempting for high earners, especially with the new 50% tax rate on the horizon.

Enterprise Zone Investments (EZIs) were first introduced in 1989 to encourage investment in commercial property in underdeveloped areas in the UK, such as the London Docklands.

Compared with other tax efficient investments, EZIs are an attractive option as they not only offer the same Capital Gains Tax shelter as Venture Capital Trusts and Enterprise Investment Schemes, but an additional 40% income tax back on the original investment.

How they work

The investor usually makes a cash contribution to an EZI syndicate equal to or higher than the higher rate tax they expect to pay in the current tax year. The remainder of the investment is funded using a limited recourse bank loan, which is to be serviced from the property's future rental income. After the investment is made, higher rate tax relief is claimed on the eligible gross investment, generating a tax rebate that broadly equates to the investor's personal cash outlay.

There are some drawbacks, as investors remain liable for the bank loan repayments if the tenant defaults, as well as any shortfall on the loan once the property is sold. However, if a quality tenant like a Government agency or large company can be found, the risk of default can be reduced, and in certain cases the Developer may be prepared to underwrite the repayments for a period if no tenant is in situ.

The way that the investment is structured means that investors can access a commercial property investment with a low initial cash outlay, due to the generous income tax relief; however, investors must be prepared to commit over the long-term.

Unlike other tax efficient investments, EZIs offer limited investment flexibility and the earliest exit opportunity is likely to be after the qualifying period of seven years. Typically, the length of an investment can be between 11-15-years and the eventual sale value for the property is not guaranteed.



EXAMPLE

An investor contributes cash of £40,000 and takes out a bank loan of £60,000 to make a total £100,000 gross investment. For tax purposes, the investment is able to be written down by 97.5%, so that £39,000 of tax relief is available at 40%. In effect, this gives the investor a stake in a commercial property for a net initial cash outlay of only £1000.

In order to avoid claw-back of the tax relief, the EZ investment must be held for a minimum of 7 years, after which the decision to sell rests in the hands of the syndicate members whereby a 75% majority vote is usually required. After the property is sold, the outstanding bank loan is redeemed and any surplus money is then distributed to the investors. It is likely that the property will be sold at a capital loss due to the premium paid initially for the benefit of the tax relief. An example is:

Sale proceeds	£60,000
Less: outstanding bank loan	<u>(£30,000)</u>
Distribution to the investor	£30,000
Initial net investment	(£1,000)
Estimated tax on net rental income over 7 years	<u>(£12,000)</u>
Post tax return	<u>£17,000</u>

In March 2008 the Chancellor confirmed that the Enterprise Zone Capital Allowances will be withdrawn from April 2011. Owing to lack of supply, and an overwhelming demand, EZ opportunities come on the market and are oversubscribed within a couple of weeks, so urgent action may be required.

This summary is for information only regarding the tax treatment of EZ syndicates. It is in generic form and does not contain investment advice which must be obtained from an FSA regulated entity. If you would like to receive more information about specific EZ investments, please contact one of the Target Financial Management team.

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