

## EIS qualifying companies – leverage and arbitrage from HMRC for capital gains tax payers?

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In October 2007, the Chancellor announced in his pre Budget report that the taxation of capital gains would be simplified, with all gains incurred after 6th April 2008 being taxed at 18%, instead of the 40% which has predominated for many years. Indexation and taper relief would be scrapped. Due to this change, which was confirmed on 24<sup>th</sup> January 2008, the tax reliefs available to investors in qualifying companies for the Enterprise Investment Scheme (“EIS”), such as Breeding Capital II and Breeding Capital III (“Breeding Capital”) become potentially even more attractive for people who have paid capital gains tax at 40% in the last three years.

As well as 20% upfront relief against income tax, tax free profits, and income tax relief on any losses, EIS companies also benefit from capital gains tax deferral relief. Any capital gain incurred in the thirty six months preceding an investment in an EIS company, or the twelve months after investment can be deferred, and any capital gains tax paid or payable can be reclaimed or deferred. Such a gain becomes taxable again in the fiscal year in which the shares in an EIS company are monetised, either through sale or a winding up, if the company fails to meet the EIS qualifying requirements, or if the investor becomes non-resident during the three years after his investment. Because of the changes in the capital gains tax regime referred to above, this is likely to create a very attractive arbitrage situation for people who have paid capital gains tax at 40% since March 2005. Let’s consider a simple example.

Mr Prospector, who has an annual six figure income, sells a property in March 2006, incurring a taxable gain, after utilising all exemptions, of £100,000. In January 2007, he pays £40,000 in capital gains tax, being £100,000 at 40%. In March 2008, Mr Prospector invests £100,000 into Breeding Capital, an EIS qualifying company. Shortly after investment, in December 2008, Mr Prospector receives an EIS3 certificate, which enables him to reduce his income tax liability by £20,000, and reclaim the capital gains tax of £40,000 he paid 12 months previously. Consequently, his net investment in Breeding Capital is £40,000.

Three possible scenarios are considered below:-

Breeding Capital performs very averagely over the next four and a half years, and is wound up in December 2012. Funds are distributed to investors in May 2013, and Mr Prospector receives back £100,000, the amount he invested. The £100,000 deferred capital gain becomes taxable in 2013/2014, so £18,000, being £100,000 at 18%, is paid to HMRC in January 2015. Mr Prospector’s £40,000 investment has yielded £82,000, more than doubling his money, and producing an IRR of 13%.

Breeding Capital performs well over the next four and a half years, and is wound up in December 2012. Funds are distributed to investors in May 2013, and Mr Prospector receives back £200,000, twice the amount he invested. The £100,000 deferred capital gain becomes taxable in 2013/2014, so £18,000, being £100,000 at 18%, is paid to HMRC in January 2015. The other gains are free of capital gains tax. Mr Prospector’s £40,000 investment has yielded £182,000, more than quadrupling his money, and producing an IRR of 29%.

Breeding Capital performs disappointingly over the next four and a half years, and is wound up in December 2012. Funds are distributed to investors in May 2013, and Mr Prospector receives back £50,000, half the amount he invested. The £100,000 deferred capital gain becomes taxable in 2013/2014, so £18,000, being £100,000 at 18%, is paid to HMRC in January 2015. The net losses of £30,000, being the £50,000 reduction in the investment less the £20,000 income tax relief Mr Prospector enjoyed, can be offset against, Mr Prospector’s income in 2012/13. This results in a £12,000 tax repayment. Mr Prospector’s £40,000 investment has yielded £44,000, marginally increasing his money, and producing an IRR of 2%.

For further details on how you can participate in Breeding Capital, please contact us on [info@breedingcapital.com](mailto:info@breedingcapital.com), or calling 0845 003 1385

The measures announced have yet to become law, and are subject to change. The tax rules and the levels and bases of taxation may change. The tax reliefs referred to in this article are those currently available or likely to be available and their value may depend on individual circumstances. If you are in any doubt about your tax position, you should consult your professional adviser.

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