

# Caught out by the 3 year rule

Burgess Hodgson is warning would-be investors that the Enterprise Investment Scheme (EIS) may not necessarily be the answer to their tax efficiency prayers.

The firm has seen an increasing number of people caught out by the EIS's 'three-year rule' – and have to pay back the tax relief they may have previously benefited from.

The EIS is a vehicle that takes advantage of tax breaks to encourage people to invest in small, often fledgling, businesses.

It pools money from a number of investors and buys shares in companies. These companies could have assets worth as little as £250,000 and are normally privately owned, although some EIS schemes invest in companies listed on the Alternative Investment Market, the FTSE's little brother.

There has to be a minimum investment of £500 worth of shares in any one company in any one, tax year.

An EIS can reduce – or even eliminate – your exposure to three ways in which the Government gets your money: income tax, capital gains tax and inheritance tax.

But it's the income tax benefit that is the main advantage. An EIS will provide upfront relief of 20 per cent. This means that, if you invested £50,000 in an EIS scheme, the 20 per cent relief would reduce your income tax bill by £10,000.

But, like all things, there's a catch or two. Firstly, you can only claim tax relief for up to £400,000 in one tax year, although you could straddle the tax year cut off and make one investment at the end of March and another on April 10, giving you a total investment 'pot' of £800,000.

While, for many small investors, this might not be too much of an inconvenience, the devil is in the detail. To qualify for the tax relief, you have to hold your investment for at least three years: if you sell it before then, you will have to give back the income tax you saved.

This would, of course, be entirely your decision. But, where Burgess Hodgson has seen a problem, is where the investors have had their income tax relief clawed back because the company in which they've invested has been sold – within the three-year period.

"It's all very well saying that you have to keep the investment for three years, but the small print doesn't say what happens if you don't," says Steve Sutton, senior partner at Burgess Hodgson, the Canterbury-based firm.

"If you invest in a successful company, it's quite likely that, within three years, they'll need a cash injection in order to grow – and somebody else will be buying them. This means you won't see any benefit from the EIS at all. Even if it's sold share for share, you'll have your tax relief claimed back. It's a hidden danger – and not very palatable for the investor."

And there are other risks, too. An EIS channels your money into smaller companies, often start-up businesses that carry a greater risk of going bust. This means not only do you not qualify for any income tax relief, but, also, you'll lose your initial investment.

And, warns Steve, it still applies on a 'paper for paper' transaction. This means that if your shares are sold to the new owner, you will still have to pay back your EIS – even though you don't actually get any cash out of the deal.

"It is a worthwhile benefit, but there are things you need to be aware of," explains Steve. "These are just some of the things we're seeing in companies that have gone into an EIS and haven't possibly realised the significance of things like the three-year rule."

Burgess Hodgson still recommends an EIS as a worthwhile investment, but, says the firm, investors should be clear about what they're buying into.

"It's a great idea, but one of the things investors have to remember – particularly minority investors – is that, if the company does do very well or needs capital and is sold within three years, then the EIS income tax relief is negated," says Steve.

"If you've sold for an increase in cash this can soften the blow – although this does of course negate part of what you were trying to do. But if you sell for paper, you don't get the income tax relief or the capital gains tax relief."

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CAUTION

EIS - 3 year rule

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# Partner profile



**Steve**<sub>Sutton</sub>

Steve was born and educated in London. After graduating at Leeds University he completed a Certificate in Education before returning to London for accountancy training.

He spent time seconded to Ernst and Young, gaining experience in corporate auditing. Despite the vibrancy of the financial world in both London and Leeds, he decided on qualifying to remain with an independent firm where he felt he would have contact with a wide variety of clients on a daily basis.

As senior partner Steve has always felt that Kent provides many different challenges. It has a very long history and a deep-rooted culture, yet has always been influenced by its closeness to Europe and the wider world. The businesses are wonderfully varied: from agriculture and education through medicine, law and manufacture to tourism and technology.

We are a leading firm of chartered accountants and business advisers, specialising in personal and corporate tax planning. Our experienced professionals have a strong reputation for providing quality technical advice and the ability to implement practical financial solutions as flexibly as our clients demand.

Building relationships has always been at the heart of our business. We understand that business success is measured by the strength of our relationships with clients. Our partners' technical skills, professionalism and business acumen is complemented by the commitment of our staff to provide our clients with the best service possible.

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# Bulletin

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Providing help to businesses and individuals on all their tax planning needs

feature article

**EIS** take  
advantage of tax  
breaks but read  
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