

Smart ideas about wealth

UNDERSTANDING ENTERPRISE ZONE SYNDICATES (EZS)

Published: 20 November 2006

This guide uses a real building with real figures taken from an EZS completed in late 2005. At the start, the figures relate to the whole building and later they are broken down to show the figures for each £100,000 “slice” of the same building.

On the back page, there is space to write down any questions you have as you are reading the guide. Each question can then be addressed with your adviser.

THE STARTING POINT

Imagine two identical freehold buildings, one in an Enterprise Zone and one not. The *Market Value* for each building (inc. the land) is £2.15m. However, the cost to buy the building in the Enterprise Zone is £2.95m!

Why pay £800,000 more? – The building in the Enterprise Zone brings with it a number of benefits and income tax relief. The benefits may include zero or reduced business rates and allowances for each new job created because of the new premises. However it is the income tax relief that benefits you most. The building itself attracts 100% income tax relief.

The building and the land sell for £2,950,000. The land (which doesn't attract tax relief) is valued at £211,515 and the building is valued at £2,738,485 but with 100% income tax relief. So £1,095,394 ($£2,738,485 \times 40\%$) is paid to the buyer(s), as a tax refund after the purchase completes. The net cost for the building & land is now £1,854,606 ($£2,950,000 - £1,095,394$)

The building has actually cost £295,394 less than the same building outside the Enterprise Zone. This is the main argument for buying in an Enterprise Zone – the eventual cost of the property is less.

What happens to the additional £800k that was “overpaid” for the building will be explained later.

THE TAX BENEFIT

A syndicate is made up of individual tax payers who come together to purchase a building in an Enterprise Zone for the sole purpose of sheltering their income tax liability. In this example, members of a syndicate have individually earned between them at least £2.95m in one tax year (ignoring any allowances and basic rate tax). The 40% tax bill they would individually have paid on this income would amount to £1.18m.

To purchase the building for £2.95m, the members must pay a 40% deposit, which would be £1.18m. You will note that this is exactly the same as their joint income tax bill. The 60% balance of £1.77m is normally funded by a non-status (no paperwork required), limited recourse (the bank can't come back to you for the loan if anything goes wrong) fixed rate mortgage – typically for 7 years or longer.

Smart ideas about wealth

Each syndicate building has a specific land:building ratio calculated by a well-known independent surveyor and agreed with the HM Revenue and Customs (HMRC). In this example, the figure was set at 92.83% ie. 92.83% of the purchase cost relates to the building. Offices tend to have a higher figure, whilst warehouses tend to be lower, due to the higher cost per foot of constructing office accommodation.

The income tax relief in this example, based on 92.83% of the total purchase value of £2.95m, is on £2,738,485 (£2,950,000 x 92.83%). Thus the value of the tax refund at 40% of £2,738,485 is £1,095,394. You will note that the difference between this refund and the £1.18m put down as a deposit is £84,606. The syndicate has therefore purchased a building with a market value of £2.15m, for just £84,606 of their own money. This is the total risk for the syndicate and is a known quantity from the outset.

Your Investment

Now let's assume you became part of the syndicate and also assume you had earned £100,000 that was taxed at 40%. The tax you would have paid on this income via PAYE would be £40,000.

You take a 1/29½ share of the building (£100,000 of a £2,950,000 building).

You put down a £40,000 deposit which you either do out of your own funds or we arrange a short-term loan. A few months later, you receive a tax refund of £37,132. The real cost to you is now only £2,868.

To explain this again another way, you have earned £100,000, paid £40,000 tax, received a £37,132 tax refund and then put a further £40,000 into the syndicate. Out of your £100,000 income, you are left with £57,132.

If you hadn't yet paid the tax via PAYE, you would pay your £40,000 tax money to the syndicate rather than to HMRC. Your tax return would show your total investment of £100,000 on which you claim tax relief of £37,132 and you send a cheque to HMRC for £2,868. Your total outgoing is £42,868 and you end up with £57,132 from your original £100,000 income.

You must now wait a minimum of 7 years before the syndicate can sell the building (although for tax purposes, you will actually create and sell a leasehold, not the freehold). Selling within the 7 years would lead to a claw-back of the income tax relief.

INCOME OVER THE 7 YEARS

The annual rent on the building is £160,125. With your £100,000 slice, your share is £5,428. However, the interest on your £60,000 share of the mortgage at 6.25% (in this example) would be £3,750, (reducing each year as the outstanding balance reduces) leaving you with a taxable profit of £1,678 (increasing each year as the interest reduces). You do not receive this money as it is used to reduce the mortgage. However, this figure is added to your gross annual income for tax purposes, which you are then likely to shelter!

Smart ideas about wealth

THE EXIT

At this point, we'll now go back to looking at the building as a whole. Over the 7 years, the mortgage has been reduced by the rental payments and now stands at £1,401,309. This is a known figure at the outset.

Let's assume the building *hasn't* increased in value over the 7 years. Although highly unlikely, it's worth looking at it from this perspective to understand the real potential.

The building is sold for its market value on Day 1 of £2.15m. With the mortgage paid off, the equity stands at £748,691. However, from this you need to recover the £84,606 originally risked to purchase the property, leaving a balance of £664,085 profit. That profit is tax free.

Now going back to your £100,000 "slice", your 1/29½ share of the net profit would be £22,511.

It's very important to remember: -

- This profit has been made using YOUR TAX MONEY.
- Only £2,868 of your own money was risked and
- We have assumed that the building hasn't increased in value.

So, in summary, if you had £100,000 of income on which you owed £40,000 tax, after 7 years you could receive £22,511 of the £40,000 back. You would have therefore effectively paid "tax" on the original £100,000 income of only £17,489 or 17.5%.

Without running through all the calculations, if the building increased in value by just 2% each year from its original market value on day 1 and was sold for this amount, ie. £2.47m, the syndicate would share a profit of £1,068,365. Each £100,000 slice would return £36,215, less the initial risk cost of £2,868, giving a tax free profit of £33,347. Your "tax cost" on the original £100,000 is now just £6,652 or 6.652%

If the building was sold for the *inflated* price you paid for it, ie. £2.95m, then the syndicate would share a profit of £1,548,691. Each £100,000 slice would return £52,498, less the initial risk cost of £2,868, giving a tax free profit of £49,630. You have now not only wiped out your entire tax bill of £40,000, but also increased your income from the original £100,000, to £109,630, totally tax free!

Capital gains tax only becomes payable on profits above this level, as until the building is sold for more than the (inflated) amount you paid for it, no CGT liability exists.

NB. For the sake of simplicity, we have ignored the fact that if you had a £40,000 tax bill to shelter, you would actually purchase a £107,724 slice of the property, (paying a deposit of £43,090) on which you would receive tax relief on £100,000 (92.83% of the £107,724) and receive a £40,000 tax refund, so you would be putting up £3,090 of your own money.

Smart ideas about wealth

Table 1

	£	£
Day 1 of Investment		
Your Tax Bill		40,000
Your Deposit = to your tax bill.	40,000	
Plus: Non-status, limited recourse loan	60,000	
Total Investment	100,000	
Tax Relief (Tax Refund) due on 93.83% of Total Investment		37,132
Your position on Day 1		-2,868
Annual Rental Income	5,428	
Less: Loan Interest on £60,000 @ 6.25%	3,750	
Taxable Income (used to reduce the loan)	1,678	
Exit 7 years after Purchase (at Day 1 Market Value)		
Sale of Property at Day 1 Market Value	72,881	
Less: Balance of outstanding loan	47,502	
Gross Profit	25,379	
Less: Your net position on Day 1		2,868
Net Profit		22,511
Exit 7 years after Purchase (2% Annual Compound Growth)		
Sale of Property	83,728	
Less: Balance of outstanding loan	47,502	
Gross Profit	36,226	
Less: Your net position on Day 1		2,868
Net Profit		33,358

MANAGING THE RISK

As these EZS's are primarily a tax planning tool, it's important that the risk is removed as far as possible. This is part of the reason why you pay an inflated value for the building at the outset. Remember, it cost £800,000 more than the same building outside of the zone.

What happens to this £800,000? Some of it is used to pay the fees of all the parties involved at the start, (lawyers, barristers, surveyors, accountants, promoters etc). The rest is used by the developer to entice high quality tenants to sign a long lease. They can use it to give rent-free periods, fit out the premises, anything that would secure a long-term lease to a good tenant. It is also used to pay the rent while the building isn't let, which in turn pays the mortgage for a given period e.g. 7 years or more.

Smart ideas about wealth

In reality, the balance of this money, together with additional funds put up by the developer*, is held by the bank in an interest bearing account and only released to the developer when the tenant is in place. If the tenant isn't of sufficiently high quality (i.e. not government or blue chip) even if they do sign a long lease, the bank only releases money back to the developer as the rents are paid or expenditure made. The bank after all is protecting its own interests. Anything that remains after the building is let is effectively a "super profit" for the developer. If the developer goes bust (remember Canary Wharf), the bank has the money and can simply appoint a new developer.

**Calculating the annual rent over 7 years, you will come out with a figure of £1.12m. The £800,000 less fees etc doesn't cover the whole of this rent, so the developer has to put up an amount calculated at the start to ensure that in the event the building is un-let, the bank has sufficient funds for the whole 7 years. Some EZS's have a rent guarantee for up to 16 years, which makes them even more attractive.*

So, from your point of view, what it means is that after you have paid your deposit, there are no other costs to be covered. You will not be called upon to pay the rent, even if the building remains un-let for 7 years. After 7 years, even if the building was still un-let, the syndicate can choose to pay the mortgage or, most likely, would most definitely sell the property.

In the event that it was un-let after the 7 year period, in between the end of the 7 year period and the date on which the property was sold, you would be liable for your share of the mortgage, which would equate to £452.33/mth per £100,000 "slice". However, of this, £135.67 is going to reduce your share of the mortgage while £287.66 is covering the monthly interest. The interest proportion is also allowable against tax and therefore you would actually be paying a net interest charge of £172.60/mth until the building was sold.

As long as it sells it for £84,606 more than the value of the outstanding mortgage, the syndicate has made a profit. If the building has to be sold for less than the outstanding mortgage, ie. "a fire sale", then although the members do not get anything back and have lost the £2,868 per £100,000 they put up, the bank has to carry the rest of the loss as it had a limited recourse mortgage.

CONCLUSION

In essence, what you are doing is saying to HMRC, "You give me back £37,132 of the £40,000 I've already paid you over the last year. I'll put up just £2,868 of my own money and borrow £60,000 from the bank on a "no risk basis". That gives me £100,000, which I shall put into a commercial property. After 7 years, I can sell the property, pay off the bank loan and keep any profit I have made tax free, as long as I don't make more than £49,630 but if I do, I will have to pay CGT", to which they reply "That's fine by us".

It comes down to whether you think that if you bought a **high quality** commercial property worth £2.15m today, gave the developer a big incentive to secure you a high quality client on a long term lease and then waited 7 years, that you could sell the property for at least £1.486m.

If you believe the commercial property market is likely to fall 30% over the next 7 years, then it's definitely not worth considering an EZS.

Smart ideas about wealth
YOUR QUESTIONS

1 _____

2 _____

3 _____

4 _____

5 _____

6 _____

7 _____

8 _____

Contacts	Telephone	Email
Jason Butler	07973 951107	jasonbutler@bloomsburyfp.co.uk
Campbell Edgar	07717 897609	campbelle@bloomsburyfp.co.uk
Carolyn Corless	07775 712969	carolync@bloomsburyfp.co.uk
Robert Lockie	07951 725880	robertl@bloomsburyfp.co.uk

Disclaimer

This document is intended for informational purposes only and no action should be taken or refrained from being taken as a consequence of it without consulting a suitably qualified and regulated person. It does not constitute financial advice under the terms of the Financial Services and Markets Act 2000. It is not an offer to sell, or a solicitation of an offer to buy, the instruments described in this document. Past performance is not an indication of future performance. Interested parties are advised to contact the entity with which they deal, or the entity that provided this document to them, if they desire further information. The information in this document has been obtained or derived from sources believed by Bloomsbury Financial Planning (BFP) to be reliable, but BFP does not represent that this information is accurate or complete. Any opinions or estimates contained in this document represent the judgement of BFP at this time, and are subject to change without notice.

BLOOMSBURY and the Bloomsbury Logo  are registered trade marks used under an exclusive sub-licence from Raymond James Investment Services Limited (RJIS). RJIS is a member of the London Stock Exchange and is authorised and regulated by the Financial Services Authority. Registered in England and Wales No. 3779657. Registered Office 77 Cornhill, London, EC3V 3QQ.