

ENTERPRISE INVESTMENT SCHEMES AND THE AMERICAN TAXPAYER

The Enterprise Investment Schemes legislation offers an intriguing investment possibility for U.S. citizens who work in the United Kingdom. High earning American expatriates, especially those on salary with large financial institutions, typically suffer from a chronic “excess foreign tax credit” position resulting from U.K. taxes on salary income substantially exceeding the 35 percent U.S. maximum tax rate on the same income. As a baseline position, the U.S. tax on salary income is the lowest amount of worldwide tax that a U.S. citizen must incur, but the U.K. additional tax charge represents an additional cost of typically up to 15 percent of an American’s salary. This additional tax charge generates “excess foreign tax credits” – foreign tax credits which exceed the U.S. tax liability on the salary income in question that can be carried back one year and carried forward for 10 years. The excess foreign tax credits, however, cannot be refunded and other than creating a possible shelter for U.S. lightly taxed earned income generated either in the prior year or in the next 10 years.

An investment in an Enterprise Investment Scheme, or EIS, may be one solution to ameliorate this chronic problem. This U.K. legislation may allow a U.S. citizen to minimize U.K. tax on earned income while at the same time the American expatriate can use excess foreign tax credits to avoid any residual U.S. tax that would otherwise apply.

The EIS scheme is designed to help smaller, high-risk U.K. trading companies raise funding from unrelated investors by providing such investors a U.K. tax subsidy provided certain conditions are met. An EIS investment can be in a variety of trading company investments from speculative start-up ventures to solar power projects to other comparatively less risky investments. An investor into an EIS is entitled to various U.K. tax reliefs, including a 30 percent reduction in U.K. tax for investments of up to £500,000 in the 2011/12 tax year (and this limit is scheduled to increase to £1,000,000 as of April 6, 2012). A U.K. taxpayer may also elect carryback relief for one year, with the effect that £1,000,000 may be invested in an EIS in the first year (although the carryback relief is only worth 20 percent tax for the 2010/11 tax year as the higher 50 percent rate of tax did not come into effect until the 2011/12 tax year).

EIS investments, however, come with certain constraints. The EIS investment must be held for at least three years or the U.K. tax benefits are clawed back. The EIS investment must be made with an unrelated enterprise and the investor may not take a controlling stake in the enterprise (currently 30 percent of the shareholder vote or as a director absent narrow circumstances).

The EIS investment must be approved by the U.K. taxing authorities and the entity itself must undertake certain reporting and similar obligations. Moreover, there cannot be a guaranteed exit strategy from the investment – effectively these are higher risk investments with a three-year holding requirement in an inherently illiquid investment.

As in any investment scenario, prudence necessarily underlies making EIS investments as U.K. tax savings, while inherently attractive, would not justify making an investment that caused a sizeable economic loss. It may be possible to invest in a fund that itself acquires multiple stakes in companies eligible for the EIS scheme which effectively spreads the risk across a number of different smaller enterprises. Such a broad based investment strategy raises the risk of the fund itself being categorized as a passive foreign investment company (a “PFIC”), which could create U.S. tax issues that may offset some of the benefits of an EIS investment. That being said, with care it should be possible to find EIS fund investments that do not qualify as PFICs, thereby spreading the risk of EIS investments while avoiding PFIC issues.

The upshot, however, is that the U.K. tax breaks associated with an EIS investment may be an attractive vehicle for U.S. expatriates. Although the U.S. citizen’s U.K. burden may be reduced below the U.S. tax charge on the same income, the use of historic excess foreign tax credits may nonetheless eliminate any residual U.S. tax that would otherwise apply.