knilljames
chartered accountants

@Knilljames

Head office: One Bell Lane, Lewes, East Sussex, BN7 1JU Tel: +44 (0)1273 480480 Email: info@knilljames.co.uk
London office: 3 Queen Square, London, WC1N 3AR Tel: +44 (0)207 843 9466

Partners: Christopher Ketley · Kevin Powell · Susan Foster · Nicholas Rawson · David W Martin
Registered to carry on audit work in the UK and regulated for a range of investment business activities by the Institute of Chartered Accountants in England and Wales.

Entrepreneurs' Relief

Entrepreneurs' Relief (ER) is a significant tax relief available on the disposal of a business. Modifications introduced by Budget 2018 mean even closer attention to the rules will be needed to ensure eligibility. The focus in this Briefing is the company shareholder, although ER is also available to unincorporated businesses.

ER basics

ER gives access to a 10% rate of capital gains tax (CGT), subject to a lifetime limit of £10 million. It applies to gains on disposals of shares and securities in a 'trading' company, or holding company of a trading group. The definition of trading company is examined below.

ER can also apply to assets (such as land and buildings) used by a company but owned by an individual, if the assets disposed of are 'associated' with the withdrawal of the individual from participation in the company.

Eligibility

New two-year rule

Ownership conditions apply throughout the period up to the date of disposal, and to access ER, the period of ownership is critical. The qualifying period was 12 months, but Budget 2018 extends this to 24 months for disposals on or after 6 April 2019.

Qualifying conditions

To qualify for ER, you must throughout the relevant qualifying period:

- hold at least 5% of the company's ordinary share capital and
- be able to exercise at least 5% of the voting rights.

For disposals on or after 29 October 2018, you must also be beneficially entitled to at least:

- 5% of the company's distributable profits and
- 5% of the assets available for distribution to equity holders in a winding up.

You must also be a company employee or office holder throughout the relevant qualifying period.

Although many factors may prompt a resignation in the run-up to a disposal, from friction among fellow director-shareholders, to pressure from prospective purchasers, directors should remain in office up to the date of disposal to avoid jeopardising an ER claim.

Trading company

A trading company is defined as one 'Carrying on trading activities whose activities do not to any substantial extent include activities that are not trading activities.' Trading activities are defined as those carried on by the company:

- in the course of, or for the purposes of, a trade being carried on by it
- for the purposes of a trade that it is preparing to carry on
- with a view to its acquiring or starting to carry on a trade
- with a view to its acquiring a significant interest in the share capital of another company that:
  - is a trading company or the holding company of a trading group, and
  - if the acquiring company is a member of a group of companies, is not a member of that group.

Substantial extent

What is meant by 'substantial' is not defined in the legislation and is thus potentially more contentious. HMRC's view is that the term means 20%, but that begs the question – 20% of what? Points such as the company's history; income from non-trading activities; and the asset base of the company would be likely to be taken into account. So, too, would expenses incurred, or time spent on company business by its officers and employees.

Beware non-trading activities

It should be noted that with property businesses, ER is restricted to Furnished Holiday Letting businesses – something the legislation defines very precisely.

One problem in the 'non-trading' area can be where a trading company accumulates a large cash balance. Here it might need to be asked whether the holding of cash is an activity, and if so, whether it fails the 20% test.

Example
John and his wife have run Hobbit Builders Ltd successfully for 20 years. Deciding to retire, they retain within the company, and then let out, the last five properties built. Trade ceases at this point. The rental income is intended to provide for their retirement. From an ER perspective, however, this means the company no longer qualifies for ER once it stops trading.

Liquidations

Relief however, is available where there is a delay between the end of trading and disposal of shares. All 5% and officer/employee conditions must be met in the 24 months leading up to cessation, and disposal of shares must take place within three years of that cessation. This means distributions in a liquidation may qualify for ER as the distributions are treated as part disposals of the shares.

For entrepreneurs whose business ceased before 29 October 2018, the one-year qualifying period will still apply.

Example
In the example of Hobbit Builders above, Hobbit ceases to qualify for ER when it ceases to trade. But any distributions made by Hobbit in the following three years may qualify for ER - if Hobbit is placed in liquidation.

Associated disposals

The disposal of an asset held outside the company may qualify for ER if it can be associated with a 'relevant material disposal'. There are three conditions:

- you must make a 'material disposal' of either the whole or part of your interest in the shares in a company
- the associated disposal is part of your withdrawal from participation in the business of the company
- the assets are in use in the business throughout the period of two years ending with the earlier of the date of the material disposal of business assets, or cessation of the business of the company (one year if business ceased before 29 October 2018).

A material disposal means you dispose of at least 5% of the ordinary share capital in the company, and there are no arrangements under which you (or a connected person) are entitled to acquire shares in that company, or a company which is a member of the same trading group.

For assets acquired on or after 13 June 2016, there is a minimum ownership period of three years ending with the date of disposal.

Maximising relief

It is judicious to take stock periodically of the maximum ER available were the company to be sold immediately. The optimal answer is £10 million x the number of shareholders. General planning points are suggested here: please contact us for advice in your circumstances.

- If you meet the basic ER requirements above, it's possible to add to your shareholding in the final 24 months, getting an additional benefit. Where shareholders are spouses or civil partners, last-minute planning has considerable potential.

Example
Shares in Crolles Breweries Ltd are owned by two husband and wife teams, Eric (40%) and Eva (10%) Rocher; and Clive (40%) and Laetitia (10%) Ferrand. Eric and Clive are company directors. Eva and Laetitia do not work in the company; nor are they office holders. An unexpected offer is made for Crolles on the basis of a quick sale. As things stand, the men will qualify for ER on their shares, but the wives will not - they aren't officers or employees and cannot be so for the 24-month qualifying period. Here however, Eva and Laetitia could consider transferring shares to their husbands, with the husbands making the disposal. This will only be of use up to a value of £10 million on each husband's disposal.

- Introducing spouses and civil partners to the business and shareholding potentially means they can claim ER separately – doubling the lifetime limit. But it's critical they work for the company for the 24-month period, and there is some possibility of HMRC challenge.
- Bringing other family members into the company can maximise ER - again paying regard to time limits, employment and share ownership rules. But note that share transfers between family members can have CGT consequences.
- There can be restrictions on ER when an associated disposal takes place, particularly when rent is paid by the company. This can happen where an individual owns a building used in the trade of their personal company, and rent is charged to the company. With forward planning, it may be possible to minimise this.

Avoiding pitfalls: the 5% problem

There have been a number of tax tribunal verdicts reinforcing the need to plan so that each shareholder satisfies the 5% shareholding requirement in the relevant qualifying period prior to the sale of shares.

One important HMRC victory went against sandwich shop owners, Mr and Mrs McQuillan. From an ER perspective, problems arose when an interest-free loan by other shareholders was converted into new shares. Carrying no dividend or voting rights, these were issued simply to accommodate the request of a government agency making a grant to the company. Although it was acknowledged that the McQuillans were exactly the sort of entrepreneurs for whom ER was designed, ER was denied because the issue of new shares took their shareholding below the 5% mark.

In another case, a business owner forfeited ER because deferred shares held by former employees reduced the owner's shareholding infinitesimally below the 5% level.

Dilution of shareholdings when raising finance

New legislation gives relief where an expanding business raises additional finance by means of the issue of new shares for cash, but as a result, an individual's shareholding is 'diluted' - falling below the 5% needed to claim ER.

For new investment taking place on or after 6 April 2019, shareholders will be able to make an election treating them as if they had disposed of their shares and immediately reacquired them at market value just before dilution. To avoid an immediate CGT bill on this deemed disposal, a further election can be made to defer the gain until such time as the shares are actually sold. ER can then be claimed in its current form. Written into the small print is a stipulation that the issue of shares is part of a genuine commercial scheme to raise capital.

Finally

Getting ER right always requires advance planning - and attention to detail. We have only been able to touch on some of the issues involved here. Please contact us to discuss in more depth how ER might affect your business.

Disclaimer - for information of users: This Briefing is published for the information of clients. It provides only an overview of the regulations in force at the date of publication and no action should be taken without consulting the detailed legislation or seeking professional advice. Therefore no responsibility for loss occasioned by any person acting or refraining from action as a result of the material contained in this Briefing can be accepted by the authors or the firm.