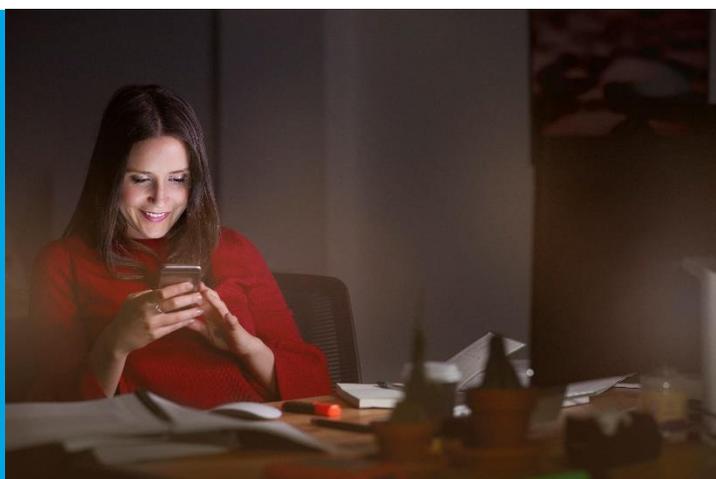


# ENTREPRENEURS' RELIEF

January 2019



## As Entrepreneurs' relief (ER) reduces the rate of capital gains tax (CGT) on disposals of certain business assets from 20% to 10%.

### What is Entrepreneurs' Relief

Entrepreneurs' relief (ER) reduces the rate of capital gains tax (CGT) on disposals of certain business assets from 20% to 10%.

The Finance Bill 2018/19 contained draft legislation outlining the two important changes to ER introduced in the 2018 Budget. The changes affect business owners and their management teams. In practice, the changes will reduce the number of shareholders entitled to claim ER, and create additional complexity in determining whether claims are valid.

### How has the ER 'holding period' changed?

The Chancellor announced an increase to the holding period for shares held by individual shareholders. Individuals will now need to hold the shares for at least 24 months rather than the current twelve months before they can claim ER on the disposal of shares.

This change will apply to disposals made on or after 6 April 2019. Individuals who have held their shares for more than one year but less than two at the date of disposal would pay a higher rate of CGT.

### What is the 5% test for Entrepreneurs' relief?

The second change immediately introduced further tests that must be satisfied before ER is available. This means that along with the existing requirement that an individual holds 5% of the ordinary share capital and votes of the company (test 1), the individual must also be 'beneficially entitled to' either:

- 5% of profits (dividends), and assets available for distribution to equity holders on a winding up of the company (test 2), or
- 5% of the sale proceeds had the whole of the ordinary share capital of the company been sold on the day of the disposal (test 3).

Any individuals who sell shares without satisfying these 5% tests (either tests 1 and 2 or tests 1 and 3) will not be eligible for ER.

When the original Finance Bill was published on October 2018, it contained only test 2. This created considerable uncertainty, notably in relation to the definition of 'equity holder' used in the calculation of an individual's entitlement.

After discussing these difficulties with professional bodies and professional firms (including BDO), in late December 2019, the Government proposed a further amendment to the Finance Bill to insert the alternative test (test 3). While still an anti-avoidance provision, test 3 is expected to be considerably more straightforward to apply.

### Why is the 5% test important?

The policy intention reflected by the Finance Bill 2018/19 is that an individual should have a 5% 'economic interest' in a company in order to qualify for ER. This addresses an anomaly or "an identified abuse of the current rules" whereby individuals could hold 5% of the votes and nominal value of the company but not have a commensurate economic interest.

This change is principally designed to affect the eligibility for ER for those who hold shares that have voting rights that are disproportionate to the entitlement to economic benefits in the company. Although, we predict there will be possibly unintended consequences for others.

These further conditions are also added to the conditions for relief on associated disposals and the withholding of relief on goodwill.

### What are the practical implications of the new 5% tests?

The virtue of the previous legislation was that it was based on objective criteria that were straightforward for individuals to apply. In seeking to address perceived avoidance, the new tests have created additional complications and uncertainty.

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When individuals look to consider whether they can claim ER they should first check that they satisfy test 1 (ie ordinary share capital and votes) for the two year holding period. If this is satisfied, they will probably next consider test 3.

Test 3 requires that, on the date of a disposal, the selling shareholding would have been entitled to 5% of the proceeds in the event of a hypothetical sale of all of the company's ordinary share capital (ie a sale of the business) on that day.

This provision operates differently from the other tests in that if the 'proceeds test' would be met on the date of the individual's disposal, the test is treated as being satisfied for the whole of the holding period (provided that test 1 is met).

If a shareholder does not satisfy test 3 then (and probably only then) are they likely to address the rigorous test 2 (which is significantly more complex).

Test 2 examines whether the shareholder is entitled to at least 5% of the profits and assets on a winding up available for distribution to the equity holders of the company. This test must be met continuously over the 24 month holding period. The legislation setting out how to measure these amounts cross-refers to complex tax rules dealing with corporate groups. It is not clear whether these rules will be suitable in the context of making calculations for ER purposes.

For example, where complex share structures exist (such as those used in many private companies) rights to net assets and dividends are not always simple to measure. In these cases, the assessment of ER qualification may require numerous share valuations over an extended period. In cases where there is discretion over dividends (such as with so-called 'alphabet shares') the shareholder may be treated as having no 'entitlement' at all and so fail the test.

In addition, calculations of the entitlements of 'equity holders' may require certain loans or preference shares to be taken into account in calculating the economic interest of particular shareholders. This will depend on whether loans satisfy a detailed definition relating to, amongst other things, whether the terms of the loan are 'commercial'. It may not be straightforward for individuals to gain certainty on this, especially where the company has institutional loan funding, from venture capitalists for instance. The calculation of entitlements may, at best, be extremely complex and, at worst, give rise to unintended outcomes and a loss of relief.

Note that if a shareholder has ceased to qualify as a result of the new tests, then even if the shareholder takes steps to restore qualification (eg by purchasing additional shares), the break in the qualifying holding period would mean that it is a further two years before ER could be claimed on the disposal of a shareholding.

Any business shareholder currently considering a disposal of shares in their company should take expert advice on whether or not Entrepreneurs' relief will be available.

## Your next steps

For further advice and information on all Entrepreneurs' Relief, please get in touch with your usual BDO contact or one of our specialists.

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### Is ER available on the sale of EMI shares affected?

Some individuals also qualify for ER by virtue of holding options over shares granted under the Enterprise Management Incentive (EMI) regime. For disposals of EMI shares from 6 April 2019, the holding period for such option holders will be extended to two years rather than the current twelve months.

The draft legislation introducing changes to the 5% rule, as outlined above, does not appear to affect EMI option holders. This means that the EMI option holders do not need to hold 5% of shares by nominal value, voting rights or economic value. This means it is still possible to grant EMI options over non-dividend bearing, non-voting shares and qualify for ER.

### What about ER on other transactions?

The changes to ER affect the availability of the relief on the sale of shares originally issued after incorporation of a trade. A transfer of trade in exchange for shares should benefit from ER, if a trade existed for at least two years prior to incorporation.

This is a positive change from the current regime that requires the resulting shares to be held for two years before disposal. The change benefits sole traders that incorporate the trade shortly prior to selling the business. The current legislation is widely drafted and could catch other transactions which involve transfers of business and the full impact is yet to be seen.

### ER on gains made before dilution

The Government announced a change that allows minority shareholders to retain their ER claim in certain circumstances where their shareholding falls below 5% due to an equity investment.

Under the new rules, a shareholder can elect to claim ER on the notional gain accrued before dilution below 5%, provided the dilution resulted from an issue of new shares for cash on a commercial basis. The ER may be claimed on the notional gain. Alternatively, tax on the gain may be deferred until the actual sale of the shares. However, in this latter case it will be necessary for the shareholder to continue to satisfy the other conditions for ER (notably employment) in order to claim relief.

The change addresses the perceived disadvantage of losing entitlement to ER by minority shareholders adversely affected by equity investment. It is intended to encourage minority shareholders not to obstruct investment opportunities and supports angel investment at early stages of business growth.

This provision does not apply to shareholders who have ceased to qualify as a result of the imposition of the further 5% tests described above.

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