ENTREPRENEURS' RELIEF

December 2018

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 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 introduces two further tests that must be satisfied before ER is available. The changes mean that along with existing conditions that an individual holds 5% of the ordinary share capital and votes of the company, the individual must also be 'entitled to':

- 5% of distributable profits (dividends), and
- 5% of assets available on a winding up of the company.

Any individuals who sell shares without satisfying these further 5% tests will not be eligible for ER.

Why is the 5% test important?

The policy intention appears to be that an individual should have a 5% 'economic interest' in a company in order to qualify for ER. This addresses an anomaly or "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 of 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 will create significant complications and uncertainty.

The first new test examines whether the shareholder is entitled to at least 5% of "the profits available to distribution to the equity holders of the company". The test for assets on a winding up imposes a similarly worded requirement.

The new legislation that explains how to measure the amounts "available for distribution to equity holders" 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 without substantial amendment.

There are a number of immediate concerns with this approach, particularly where this is calculated over the extended two-year period:

With complex share structures, such as those used in many private companies, rights to net assets and dividends are not always simple to measure. There may be elements of discretion or different types of vesting for shares such as upwards or downward ratchets.

Entitlement to a share of net assets and dividends can also vary depending on the value of the company. For example, where some share classes participate only once certain 'hurdles' have been exceeded or returns are linked to performance. In these cases, the assessment of ER qualification would seem to require numerous share valuations over an extended period.

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Many private and family companies do not have shares that rank equally for dividends. Instead, they will have the flexibility for dividends to be paid on one class of share but not others depending on the financial needs of the shareholders. In such cases, it is not clear that anyone has an 'entitlement' to dividends until they are declared, and the proportions may vary from one dividend to the next.

For such companies, it is hard to believe that HMRC intends that no shareholders at all will qualify for ER on a disposal and yet that would seem to be the consequence of the draft legislation.

Loans and preference shares that satisfy a detailed definition are excluded from the value of the company for the 5% tests. However, the new tests require other loans and preference shares to be taken into account.

In particular, loans that are convertible into shares or which exceed a commercial return will be treated as equity for these purposes. A company with institutional funding via such loans, from venture capitalists for instance, may find the ordinary shareholders' entitlements swamped - so that even majority shareholders who are be bona fide entrepreneurs might not be eligible for relief.

The complications involved in these definitions, imported from the Corporation Taxes Act 2010, will create disproportionate difficulties for individual shareholders seeking to claim ER. It may be feasible for a company with a finance department and professional advisers to ascertain whether a loan is at 'commercial rate' and so excluded from the calculation of equity returns. However, this will be an onerous, and possibly unrealistic, task for many individual shareholders.

If a shareholder has ceased to qualify as a result of these new tests, then even if the shareholder takes steps to restore qualification, 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 Entrepreneur's relief will be available.

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, do 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 dividend rights. This means it is still possible to grant EMI options over non-dividend bearing, non-voting shares.

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 change from a 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 of equity investment.

Under the new rules, a shareholder can elect to claim ER on the gains accrued before dilution below 5%, provided the dilution resulted from an issue of new shares for cash. The ER will be claimed on the eventual disposal of qualifying shares.

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.

Disappointingly, 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.

Your next steps

For further advice and information on the above article, please get in touch with your usual BDO contact or one of our specialists listed overleaf.