

Entrepreneurs' relief

Entrepreneurs' relief (ER) is a preferential rate of capital gains tax (CGT) that is available on capital gains made on the disposal of trading businesses. The preferential rate is 10% and it is available on gains of up to £10m during an individual's lifetime. ER is a very important tax relief for any business owner contemplating the sale of a business in future.

In order to obtain ER there must be a disposal of qualifying business assets which includes disposals by:

Shareholders - shares in trading companies including the holding company of a trading group

Partners - partnership share in a trading partnership, or

Sole-traders - on cessation of the whole or part of a trading business.

Where there is a qualifying disposal, then ER can be extended to cover the disposal of assets outside of the business (associated disposals) or by trustees. Property letting and investment businesses do not qualify as trading businesses although the letting of furnished holiday accommodation can qualify for ER.

Income tax takes priority over CGT so where a gain is taxable to income such as where the employment related securities rules apply or where the income based carried interest rules apply or where the liquidation targeted anti-avoidance rules apply (amongst others) then ER will not be available and the higher income tax rates will be payable.

Shareholders

To qualify for ER shareholders in a trading company or in the holding company of a trading group must:

- Hold 5% or more of the ordinary share capital in the company being disposed of (ordinary shares are (broadly) all shares in issue other than fixed rate preference shares).
- Be entitled - by reason of their shareholding - to at least 5% of the voting rights.
- Be entitled - by reason of their shareholding - to at least 5% of the net assets on a winding up and at least 5% of income distributions (conditions announced in the 2018 Budget effective from 29 October 2018).
- Be officers or employees of the company, or a group company.
- Have fulfilled those conditions throughout the two years leading up to the disposal (this period was previously one year, but was changed in the 2018 Budget for disposals after 5 April 2019).

Where a business ceases after 29 October 2018 and the disposal is on or after 6 April 2019, the various conditions will need to have been met for the two year period to cessation. Where the business ceased before 29 October 2018, the existing one year qualifying period will continue to apply.

The new qualifying conditions introduced by the 2018 Budget are intended to prevent contrived structuring to achieve the minimum 5% shareholding requirement but without having an underlying equivalent economic interest in the company. The new conditions will impact which shares qualify for ER, and careful consideration of share structures should be undertaken, including the impact of loan capital.

A company is a trading company if no more than 20% of its 'value' is from non-

trading activities. If the 20% threshold is breached then entitlement to ER is lost in its entirety. The 20% threshold is measured on case law principles, in the round, by reference to turnover, profitability, net assets and management time. The holding of cash is not an activity in itself and so care is required before a decision is made by the board to invest surplus cash from trading.

Special rules apply to enterprise management incentive (EMI) shares. The one year (two years, from 6 April 2019) ER holding period runs from the grant of the EMI option and the 5% holding tests do not apply.

Where individuals dispose of shares which were received as consideration for transferring their business to the company (taking advantage of incorporation relief), the pre-transfer period will be taken into account in deciding whether the two year qualifying condition is met.

From 6 April 2019 where there is an issue of shares for cash which causes an individual to be diluted to below the 5% threshold then it is proposed that the individual will be able to elect to trigger a gain when the new investment occurs and separately to elect to defer the gain until the ultimate sale of the shares. The election will allow the individual to benefit from ER when it would otherwise have been lost.

As a result of the 2018 Budget changes, companies with more than one share class will need to review their position to ensure that commercial funding arrangements of the company, including loans and preference shares will not now impact on the availability of relief for the owners. Shareholders should seek early advice in relation to their share structure to ensure they qualify for ER and there are no nasty surprises prior to an exit.

Partners and sole-traders

Partners and sole-traders can also claim ER on disposals. For sole-traders, usually the entire business will need to be sold - if you only sell part of a business, that part must be capable of being carried on separately as a going concern. For partners and shareholders, the disposal must be 'material' - over 5% of a partnership or a reduction in your shareholding representing at least 5% of the relevant shares or securities of the entity as a whole. The 5% requirement does not apply where you dispose of the whole of your remaining interest where you have previously held a larger stake.

The disposal of a business interest may qualify for the relief providing the following conditions are met:

- The business must be a trade, profession or vocation. This includes commercial letting of furnished holiday accommodation and
- The individual must have owned the business or held an interest in the business throughout the two years (from 6 April 2019, previously one year) leading up to the date of sale.

For partners, the tax legislation looks through the partnership arrangement and imputes the proportionate share of the assets to the partner. ER is available on disposal in respect of the trading assets within the partnership only.

In the event that the business ceases trading, ER is available on capital gains arising on assets used in the business, providing these are sold within three years of cessation.

Assets owned outside of a company or partnership but used in the business

Where the relevant conditions are met, ER can be extended to include gains made on 'associated disposals' of assets owned personally, but used in the company's, or partnership's, trade. An example is where an individual shareholder personally owns the property from which the company trades and the property is to be sold at the same time as his shares in the company are sold.

This extension to ER is well established but is considered to have been abused such that in 2016, a number of further conditions were introduced to avoid contrived arrangements - for example where farmland was being sold for residential property development.

In particular, the following conditions apply:

- The individual must dispose of the whole of their interest, or at least a 5% holding in the partnership or company. The disposal must be made as part of the withdrawal from participation in the business.
- The associated asset disposed of must have been used in that business throughout the one year (two years from April 2019) ending with either the disposal or cessation of the partnership or company.
- The asset must have been owned for at least three years.
- There must be no re-purchase arrangements.

Care should be taken where a full commercial rent is being charged to the business for the use of the property, or where an asset has not been used in the business throughout the period, as this may result in the relief being denied or restricted. In addition, ER is not available on the disposal of goodwill on the transfer of a business to a close company to which the individual transferring the goodwill is related, and there are other complications which can arise on transfers from unincorporated businesses to companies.

Partners who receive a capital sum on retirement, can still benefit from ER, if the settlement deed is correctly structured, however care is needed. The conditions for ER and associated disposals are complex and care is required to ensure that all relevant conditions are met.

Trustees

For trustees to qualify for the relief on either the sale of shares or on business interests, the following conditions need to be met

- The beneficiary must hold an interest in possession, and
- In the case of shares, the beneficiary must be an officer or employee of the trading company and own at least 5% of the ordinary share capital, voting rights, distributable income and net assets on a winding up.

The second condition must be met throughout the two years (from 6 April 2019, previously one year) leading up to the date of sale.

Discretionary trusts cannot qualify for ER unless an interest in possession is granted to a shareholder who meets the qualifying conditions in their own right. The two year time limit means that advance planning is required by trustees in order to qualify.

ER is a very valuable, but increasingly complex relief. The relief has been tightened up in recent years and it is very possible that further restrictions will be introduced in future. It is possible to take planning action to crystallise the value of ER as part of a family succession arrangement and business owners attracted to that idea should consider taking advice on that at an early stage.

Contact us

If you require assistance regarding entrepreneurs' relief, please contact one of the experts below who can offer you the advice that you will need:

Damian Lannon

damian.lannon@pkf-francisclark.co.uk

Adam Kefford

adam.kefford@pkf-francisclark.co.uk

Holly Bedford

holly.bedford@pkf-francisclark.co.uk

Gordon Fox

gordon.fox@pkf-francisclark.co.uk

Daniel Sladen

daniel.sladen@pkf-francisclark.co.uk

www.pkf-francisclark.co.uk

Reviewd: 06/11/18



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