

Hold on to 10%

RICHARD HOLME and **STEPH PARKER** look at some practical issues on entrepreneurs' relief.

Entrepreneurs' relief has been with us for just over three years so we now have considerable experience in advising clients on ensuring they are entitled to this valuable relief – and also preventing any pitfalls from occurring.

The stakes are higher than ever, as over a lifetime an individual can make £10 million of gains qualifying for the relief. So if something goes wrong and capital gains tax at 28% is due, rather than 10%, the taxpayer may be faced with an additional £1.8 million tax liability and he may look to the hapless adviser to settle this if timely advice has been absent.

It is therefore essential that tax advisers review, in particular, shareholdings in all client trading companies with a view to maximising entrepreneurs' relief and ensuring that, wherever possible, shareholders not only have at least 5% of the shares and voting rights, but are also officers or employees of the company in question. In some situations where shares have been transferred to a spouse to mitigate income tax there have been disastrous effects on the capital gains tax position. See *Share transfer*.

In this scenario, last minute attempts might be made by some advisers to enable entrepreneurs' relief to be claimed by appointing the spouse as a director, officer or employee or transferring the shares back to the other spouse. However, a one-year ownership period is needed before a qualifying disposal. It could be embarrassing, let alone commercially inopportune, if an appetising exit has to be deferred in consequence, or more risky arrangements (such as cross options or conditional contracts) are entered into with a view to deferring the date of disposal for CGT purposes until entrepreneurs' relief is available.

What is a trading company?

The tax adviser may also be looking to ensure that shares qualify for business property relief for inheritance tax purposes. This



may be the case where perhaps there is doubt as to whether the company is a trading company for CGT purposes, although the definitions for the purposes of IHT and CGT are (subtly) different.

For CGT purposes, 'trading company' is defined in TCGA 1992, s 165A(3) as 'a company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities'. This is the same definition used under the previous taper relief regime and gives rise to similar potential difficulties in practice. It is understood that HMRC will regard any activity as not being 'substantial' if it comprises less than 20% of the company's activities. Therefore attention needs to be paid to aspects such as the level of assets, turnover, profit and number of employees engaged in trading and non-trading activities. Problem areas may arise, as they did with taper relief, where it is perceived that the company may have cash in excess of its current trading requirements. See *Cash*.

Many trading companies may have sublet premises surplus to requirements or they may be lying vacant. No difficulties should arise because these should not be regarded as non-trading activities in the current economic climate.

It has been suggested by some that an effective means of accessing profits in a trading company is for director-shareholders

KEY POINTS

- Transferring shares to spouse.
- Application of the 5% de minimis requirement.
- Entrepreneurs' relief and trusts.
- Advantages of a formal liquidation.
- Timing of entrepreneurs' relief claim.

SHARE TRANSFER

Eric is a director and owns one-third of Keech Ltd with the balance held by external shareholders. He transfers his entire shareholding to his wife Fredrika, so that she can enjoy a lower rate of tax on dividend income. Eric then tells his tax adviser that an offer has been made to sell the whole company for a £3 million gain. As Fredrika is not an officer or employee of the company, she will have to pay 28% CGT on her £1 million gain, i.e. £280,000 rather than the £100,000 Eric would have paid.

CASH

Alison Ltd trades as a recruitment consultant and, due to high profits, has built up a bank balance of £400,000. This comprises 35% of gross assets and 25% of net assets, but the directors have minuted to confirm they are retaining this cash for future business purposes. In this situation, there would be no difficulty in the shareholders claiming entrepreneurs' relief on a disposal. This is because the cash has been generated from trading operations and is being retained for that very purpose; it is not an investment activity. In the current difficult recessionary climate this could be an especially convincing argument to put forward.

to take loans from the company. Rather than pay tax on dividends at effective rates of up to 36.1%, the shareholder could take a loan on which the company would need to account for tax at only 25% under CTA 2010, s 455. Not only is the overall tax burden less, but it is borne by the company and the debt should be deductible for IHT purposes on death.

The question arises, though, as to whether the loan is actually an aspect of the company's trading operations or whether it is to be regarded as an investment activity.

The cautious view would be to avoid charging interest on the loan account (although this gives rise to an income tax charge under ITEPA 2003, s 175) so that this asset has less prospect of being characterised as an income-bearing investment and thus prejudicing the company's status for entrepreneurs' relief purposes.

Watching that 5% threshold

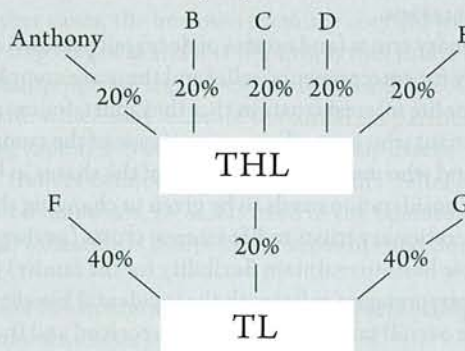
In limited cases there may be a very large number of individuals involved in a business, each of whom owns perhaps less than 5% of the equity in the new business. There is no 5% de minimis for partnership interests so it might have been preferable for them to invest through a limited liability partnership. Otherwise it has been suggested that the use of an intermediate holding company could be of some use in enabling minority shareholders to obtain

TRUSTS

The Emily Discretionary Trust owns 20% of Ukulele Ltd and disposal of that company could take place in the next two to three years. The trust would pay CGT at 28%. However, by converting to a life interest trust at least a year before disposal, and by transferring at least 5% of the shares to Tom, the life tenant, who is a director of the company, not only can the trust claim entrepreneurs' relief but Tom can as well. Consideration must be given to the life tenant's other business interests, though, as the trust's entrepreneurs' relief claim will use Tom's lifetime limit of £10 million; it does not have a £10 million allowance of its own. Tom may not be inclined to agree to the joint claim required under TCGA 1992, s 169M(2)(a) if he does not benefit fully from the trust's capital.

5% THRESHOLD

Anthony is setting up Thomas Ltd (TL) with six other people (B, C, D, E, F and G) and plans to have 4% of the equity, as will four others, with the remaining two shareholders each owning 40%. As five shareholders will have less than 5% of the shares, they decide to form their own company, Thomas Holdings Ltd (THL), which owns 20% of Thomas Ltd. Since they have at least 5% of THL, and Thomas Ltd is a trading joint-venture company in which THL owns a qualifying shareholding of at least 10% (see TCGA 1992 s 165A(14), as applied by s 169S(5)), there should be no difficulty in obtaining entrepreneurs' relief on a sale of THL, provided an ultimate purchaser is willing to buy the shares in that company.



the benefits of entrepreneurs' relief, using the joint venture provisions (s 165A(14)). See **5% threshold**.

Another area of difficulty on the critical 5% threshold is where the exercise of share options on an exit causes the percentages held by longer standing shareholders to dip at the last minute with the result that entrepreneurs' relief is not available. If this situation can be predicted, the share option arrangements can be replaced by cash compensation to prevent a costly loss of the relief for others.

Directors, officers, employees?

There may in practice be a reluctance to appoint certain family member shareholders as officers or employees and it is generally regarded that a director or officer does not need to be paid or even perform any significant duties, let alone work full-time. To give substance to any employment where entrepreneurs' relief is in point, it is important to show that any employees are paid in order to underpin this status.

Sometimes with an overseas company it may be the case that a significant UK-resident shareholder is not a director so as to reduce any prospects of the company being regarded by HMRC as centrally managed and controlled in the UK, and hence UK-tax resident. In that scenario, it will be preferred if the individual is, say, company secretary, as this post is an office and, all other things being equal, will allow entrepreneurs' relief to be claimed by the shareholder on a disposal of his shares.

Trust aspects and concerns

Difficulty may arise with trust shareholdings, as many families have chosen to retain flexibility by using discretionary trusts to hold shareholdings. They are also used for IHT reasons, on the

RENTAL PROPERTIES

Debbie runs a chain of rental properties and has done so for many years. In June 2010, she starts to let the properties on a holiday-let basis and when she sells in August 2012 she is able to claim entrepreneurs' relief as in the 12-month qualifying period she is carrying on a qualifying business.

first death in a married couple or civil partnership, so that the business or agricultural property is not within the estate of the surviving spouse. Historically, settlor-interested discretionary trusts may survive from the days of the now defunct taper relief where they served to maximise availability. Their CGT status needs urgent review.

Discretionary trusts (and estates of deceased persons) will never qualify for entrepreneurs' relief and there are complex provisions for life interest trusts in that they must, for example, have a life tenant who is an officer or employee of the company concerned and who must have at least 5% of the shares in his own right. Consideration needs to be given to changing the status of discretionary trusts to life interest trusts (perhaps on a revocable basis to maintain flexibility for the family) to maximise entrepreneurs' relief with the incidental benefit of reducing the overall tax rate on dividends received and then distributed. See *Trusts*.

An offshore trust can make tax-free gains provided settled by a non dom. If a capital payment is made to a UK-resident beneficiary, a CGT liability may arise, but entrepreneurs' relief should be available in principle. If the capital payment is made outside the normal time limits in which a claim for entrepreneurs' relief must be made under s 169M(3), it is understood that HMRC may well allow the relief in this situation.

The relevant point is that the time limit for the claim relates to the original disposal rather than to the capital payment which might take place several years later.

Winding up companies

Many clients wish to use lower corporate tax rates on profits through the use of limited companies which might undertake, for example, a property development or act as a corporate partner. In some such cases there may be perceived benefits in profits being retained with a view to winding up the company in a number of years with shareholders claiming entrepreneurs' relief, on the basis that it is better to pay 10% CGT than suffer 36.1% tax on dividends now.

It is understood that to avoid the transactions in securities provisions of ITA 2007, s 687 and enjoy CGT treatment, it would be prudent for the company to be wound up through a formal liquidation (see HMRC's *Company Taxation Manual* CTM 36850).

There may still be difficulties with the trading status of such a company if substantial cash balances have been generated and thus entrepreneurs' relief may be unavailable. To minimise the prospects of an HMRC challenge, consideration might be given to the company concerned becoming engaged in other trading operations through involvement in other qualifying trades, such as film partnerships or holiday lets, so as to use the cash.

WHEN TO CLAIM

Diana sells Dove Ltd for a £1 million gain in February 2010 and could claim entrepreneurs' relief. She then sells Badger Ltd for a £10 million gain in November 2010. She chooses to claim the relief against the gain made in November that would otherwise be charged at 28%, and to pay 18% CGT on the February 2010 gain.

Holiday lets and mixed-use assets

The disposal of qualifying furnished holiday lets will qualify for entrepreneurs' relief provided certain conditions are satisfied. See *Rental properties*. It should be noted that, in all probability, they need only to be satisfied in a one-year period prior to the disposal although the matter is not entirely clear.

Generally for disposals of business assets or businesses, there does not appear to be any apportionment of the period of ownership between qualifying and non-qualifying purposes as is required for associated disposals (TCGA 1992, s 169P(4)(b)). The use of this provision could be helpful if, in the latter stages of the ownership of some valuable land, a qualifying trade has been carried on.

A holiday let may also have been used as a family residence and hence in addition to entrepreneurs' relief, an election under TCGA 1992, s 222(5) may reduce any CGT due on disposal, particularly through the application of s 223(2)(a).

Claiming and disclaiming

The entrepreneurs' relief provisions have been little changed since they were introduced, but we have seen generous increases in amounts of gains qualifying for the relief from the original £1 million to £5 million and now £10 million. It should be remembered that it is not mandatory to claim the relief. See *When to claim*.

In this situation, s 169M makes it clear that relief must be claimed but can then be disclaimed within the appropriate time limit, which is 22 months after the end of the tax year of the qualifying business disposal.

Paying 'up front'

There have been important changes in the availability of entrepreneurs' relief where shares in a personal company are sold for shares or securities in a predator which is not the vendor's personal company. This means that it may not be possible to claim the relief when the paper proceeds are disposed of. There may be situations where it is appropriate to use the provisions of s 169Q(2) to pay CGT 'up front' even on such 'paper' consideration. See *Advance payment*.

Sometimes an individual cannot claim entrepreneurs' relief and is faced with a 28% CGT charge. The CGT may be only paid at 18% where an individual has a low taxable income, below around £42,475. Such individuals could consider transferring shares to spouses and children just before a sale to take advantage of their CGT annual exemptions and the lower-rate bands for children. It is key in this situation to ensure

that these are genuine gifts and any proceeds are solely for the benefit of the transferee family members.

Sometimes there might be unexpected good news in that entrepreneurs' relief may be available, in seemingly unlikely circumstances, as shown in *Good outcome*.

Lastly, it is important to ensure that any premises (or other chargeable assets) qualify for entrepreneurs' relief on a disposal, if held outside the business. It is well known that the payment of a rent since April 2008 will restrict relief and it is important that the disposal is associated with the vendor's withdrawal from the business.

If one of such premises is being sold, but the associated business (presently conducted as a partnership) is being continued, entrepreneurs' relief would be available if the

ADVANCE PAYMENT

Nicola is selling King Ltd in August 2011 for £1 million cash, two million shares in a fully listed company and £2 million loan notes, with the entire proceeds representing a gain. TCGA 1992, s 135 could allow the gain on the shares and loan notes to be deferred until they are disposed of, but 28% CGT would be payable on their ultimate disposal. Although it would still be prudent to go for clearance under s 138, Nicola would probably be well advised to elect under s 169Q(2) to pay the CGT on the entire consideration in 2011/12 at 10%.

GOOD OUTCOME

You are approached in June 2011 by shareholders in Charlie Ltd, an investment company holding £10 million cash, owned by Felix and Florence. On making enquiries, you ascertain that Charlie Ltd traded until September 2008 and the cash arose from the sale of its trade. Entrepreneurs' relief can be claimed by Felix and Florence provided they are still officers or employees and the company is wound up within the three-year time limit prescribed by s 169I(7).

partners' 'withdrawal from the business' was triggered by incorporating the business, so their direct involvement ceased.

In other cases, the business premises are held within the partnership business and it is important that this is evidenced through appropriate legal documentation and accounting treatment, which may indicate that different partners have differing capital entitlements to partnership assets.

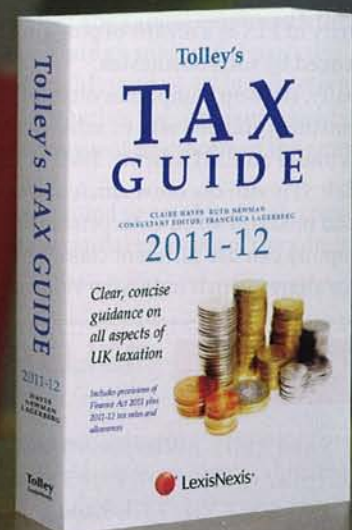
Sole traders cannot claim entrepreneurs' relief for associated disposals, so assets used in the business should be included as business assets in the accounts and documented as such.

Similar considerations may apply to a partnership with one equity and a number of salaried partners.

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