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Entrepreneurs' Relief

Entrepreneurs' Relief (ER) has been around for many years. However, it appears that HMRC are now taking a more active interest in ER claims and the Government has recently tweaked some of the rules. We consider below the main rules in respect of individual shareholders in limited companies.

What are the basic conditions?

ER applies to gains on disposals of shares (and securities) in a trading company (or the holding company of a trading group) provided that the individual making the disposal:

- has been an officer or employee of the company, or of a company in the same group of companies throughout the year leading up to the disposal of the shares; and
- throughout that period owns at least 5% of the ordinary share capital of the company and that holding enables the individual to exercise at least 5% of the voting rights in that company.

12 month period

It is critical that the tests are met throughout the 12 months up to the date of disposal. What happened before this is not relevant.

The term 'officer of the company' is not defined, so being an unpaid company secretary would, for example, meet the definition. The same issue applies to employment in that the term is not defined – being paid to work 2 hours per week would be good enough. However, this is an area HMRC are interested in.

In a recent case, a husband and wife sold their shares. They both met the 5% test but the wife had been given a P45 prior to the sale at the insistence of the buyer. HMRC argued that she could not be an employee. Due to the specific circumstances of the case the Tribunal did not agree with HMRC but the case illustrates how critical the two tests are.

Make sure basic conditions are in place

A simple question now needs to be asked in the case of every family company:

'If there was a sale of the company today – what would be the maximum ER which would be available?'

The ideal answer should be £10 million x number of shareholders.

If that answer is not the case then the question to consider is what steps need to be taken to make sure that it will apply bearing in mind that there is a minimum qualifying period of 12 months which must be satisfied.

Planning if basic conditions are in place

Provided that an individual meets the basic requirements detailed above they can have further shares added to their holding within that final period and those shares will qualify for ER. Where shareholders are spouses or civil partners, some last minute planning can enable a better ER position to be obtained as the following example shows.

Example

The shares in Helpringham Breweries Ltd are owned as follows:

Ted Robinson 40%

John Robinson 40%

Betty Robinson (wife of Ted) 10%

Jane Robinson (wife of John) 10%

Base cost of the shares is negligible.

Ted and John are the directors of the company. Neither Betty nor Jane work in the company and are not office holders.

An unexpected offer is made for the company provided a quick sale can be arranged. As things stand, Ted and John will qualify for ER on their shares because they are officers and meet the shareholding requirement. Betty and Jane do meet the shareholding requirement but because they are not officers/employees and cannot be so for a period of twelve months leading up to the sale, their disposals will not qualify.

What can be considered in a situation like this would be for Betty and Jane to transfer their shares to their husbands and for them to make the disposal. This will only be advantageous up to a value of £10 million on each husband's disposal.



What is a trading company?

The definition of a trading company is:

'...a company carrying on trading activities whose activities do not to any substantial extent include activities that are not trading activities.'

The legislation defines 'trading activities' as activities 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.

There is no definition of 'substantial' in the legislation and so this is an area of some uncertainty. HMRC's view is that the term means 20% but 20% of what? Their view is that some or all of the following are among the measures that might be taken into account in reviewing a particular company's status:

1. Income from non-trading activities.
2. The asset base of the company.
3. Expenses incurred, or time spent, by officers and employees of the company in undertaking its activities.
4. The company's history.

It may be that some indicators point one way and others the opposite way. HMRC suggest that the factors should be looked at in the round.

Beware non-trading activities

One area of concern has historically been that of an otherwise trading company accumulating a large cash balance. There are two points to note, namely:

- Is the holding of cash an activity?
- If so, does it fail the 20% test?

Interestingly, there is no public case where HMRC have tried to argue that a large cash balance means no ER.



However, consider the following example.

Example

John and his wife have run a building company successfully for 20 years. They decide to retire but retain the last five properties built by the company, within the company, which are then let out. The intention is that the income will provide them with an income in retirement.

This will mean the company will cease to qualify for ER once it ceases to trade.

Liquidations

Relief is however available where there is a delay between the cessation of trading by the company and the disposal of the shares. The two conditions set out above (i.e. 5% and officer/employee) need to be met in the twelve months leading up to the cessation of the trade by the company and the disposal of the shares needs to take place within three years of that cessation. This enables distributions in a liquidation to qualify potentially for ER as the distributions are treated as part disposals of the shares.

Example

In the previous example the company will cease to qualify for ER once it ceases to trade.

However, any distributions made by the company in the following three years may qualify for ER if the company is placed into liquidation.

Associated disposals - what are they?

The disposal of an asset held outside of the company may qualify for ER if it can be associated with a 'relevant material disposal'. This means that three conditions have to be satisfied:

- The individual makes a 'material disposal' of either the whole or part of their interest in the shares in a company.
- The associated disposal is made as part of the withdrawal of the individual from participation in the business of the company. HMRC guidance suggests that it is not necessary for the individual to actually reduce the amount of work which they do for the company.
- The assets are in use in the business throughout the period of one year ending with the earlier of the date of the material disposal of business assets or the cessation of the business of the company.

What is a 'material disposal' has recently been clarified. The individual must dispose

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

Associated disposals – restrictions of relief

An associated disposal may have ER restricted to take account of specific circumstances. The significant point to note here is that although the basic requirement for ER considers the one year test, in this situation it is necessary to look at what has happened not just in that final one year period but throughout the whole period of ownership of the asset by the individual. This can make a significant difference to the amount of relief.

There are a number of restrictions which may apply if the asset has not been used in the business throughout the period of ownership, the asset has only been partly used for business purposes or if the individual has only been involved in the business for part of time the asset has been used. However, possibly the most significant restriction relates to the payment of rent by the company.

Where the property has been rented to the company a restriction is to be made by reference to the extent to which rent has been charged for periods after 6 April 2008.

Example

Dick has owned the property for 20 years and throughout that period the property has been used by the company. Rent has been paid at a market value rate throughout the period. The property is sold on 6 April 2015 which results in a capital gain of £750,000. The gain which qualifies for ER will be a fraction based on the period from the date of ownership up to 6 April 2008 (13 years) over the total period of ownership, that is:

$$£750,000 \times 13/20 = £487,500.$$

Planning is the key

The availability of ER is not straight-forward and the above only deals with the easier situation i.e. selling for cash. As always, advance planning is the key. If you have any questions about the above or are considering selling your company, please do get in touch with us.