TRIALS AND TRIBULATIONS

Peter Rayney explains the potential pitfalls for business owners considering the use of entrepreneurs' relief

Entrepreneurs' relief is one of the main tax breaks designed to encourage business and entrepreneurship. Like many other tax reliefs, it is riddled with complexity. Furthermore, since the entrepreneurs' relief regime was radically improved in 2010 and 2011, some have attempted to exploit it in situations that were not intended by the legislature. Of course, this is the familiar tale for so many well-intentioned tax reliefs. The unfortunate consequence of this is that the legislation now contains many traps for 'unsuspecting' entrepreneurs who are making genuine disposals of their business interests.

In my experience, there are many cases where competent claims for entrepreneurs' relief could not be made or were rejected by HMRC due to a failure to consider the 'small print' of the tax law. This article is based on those practical experiences, setting out tips and potential pitfalls.

1. Are you selling a business or part of one?

Sole traders can only obtain entrepreneurs' relief if they sell the whole or part of their business (that has been carried on for at least one year). It is not always easy to determine whether there has been a disposal of part of a business as opposed to a business asset/assets. It is therefore perhaps not surprising that many claims have floundered on this particular point.

This is a topical area since many farmers (and estates) are currently being enticed to sell off large parcels of land to developers for much needed house building projects. Many landowners think that such disposals will automatically qualify for entrepreneurs' relief. However, to secure entrepreneurs' relief it is necessary to demonstrate that they have sold a distinct part of their business as opposed to an asset used in the business.

It should also be mentioned that sales that provide the landowner a share of the development profits might be potentially vulnerable to penal income tax rates under the Finance Act 2016 (FA 2016) transactions in land rules.

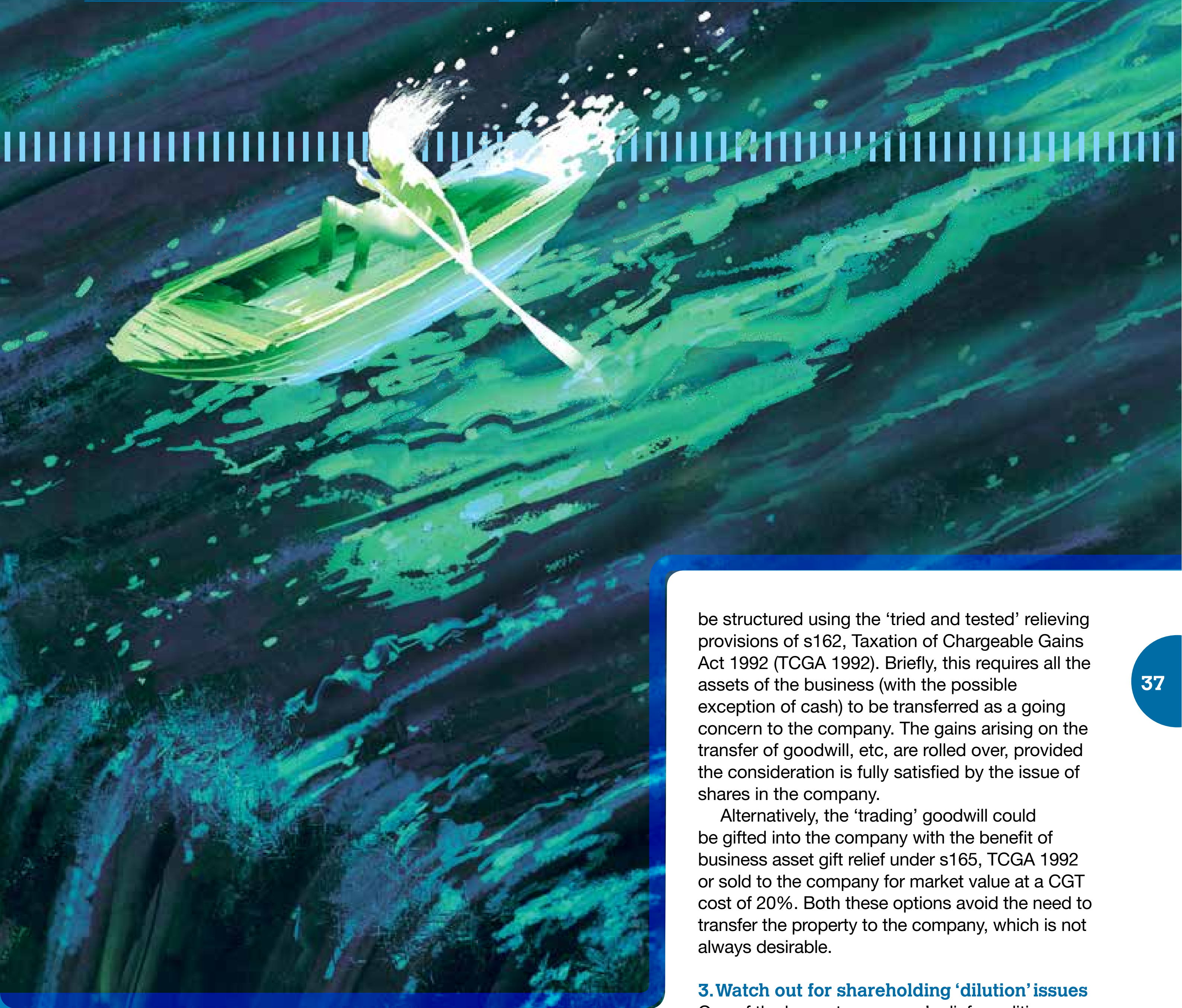
> **One of the key ER conditions on share sales requires the owner manager to hold at least 5% of ordinary share capital and 5% of the voting rights**

There is a long line of jurisprudence showing that a partial sale of farmland does not normally constitute a disposal of part of a business – see, for example, *McGregor v Adcock (1977) STC 206*, *Mannion v Johnston* 1988 *STC 758*, and *Pepper v Daffurn (1993) STC 466*. These are all 'old' retirement relief cases but they still provide a persuasive precedent for entrepreneurs' relief, since it is based on similar legislative wording.

On the other hand, in *Gilbert (t/a United Foods) [2011] TC 01542*, the First Tier Tribunal accepted that entrepreneurs' relief was available on the sale of a part of a business. This involved an independent sales representative, who acted for nine different wholesale food suppliers. He sold the business that related to one of these suppliers as a going concern. This comprised customers' lists, goodwill, trademarks, and so on. The tribunal found that these assets could be operated as a separate business (and indeed the disposal was accepted as a transfer of a going concern for VAT purposes). The *Gilbert* case shows it is possible 'to get over the line' where the sale of part of a composite trade 'is still recognisable as a business when separated from the composite whole'.

2. Is it possible to benefit from entrepreneurs' relief when incorporating a sole trade/ partnership business?

It is no longer possible for sole traders and partnerships/limited liability partnerships (LLPs)



to sell goodwill to a 'connected' company and obtain the benefit of entrepreneurs' relief. This was blocked in December 2014 since the government (finally) decided it was unacceptable tax planning.

Before the abolition, there had been many 'tax-driven' incorporations that typically involved the sale of goodwill at market value to connected companies. This was achieved at a 10% capital gains tax (CGT) cost (with the benefit of entrepreneurs' relief). The consideration for the sale was being left outstanding on loan account, which was subsequently repaid, thus providing tax-efficient extraction from the company.

On the other hand, it is still possible to claim entrepreneurs' relief on the sale of property (transferred with the business, see point 1 above) to a connected company, although depending on the precise circumstances this may trigger a stamp duty land tax (SDLT) charge based on the market value of the property (although partnerships and LLPs may be able to mitigate this). Most business incorporations now tend to be structured using the 'tried and tested' relieving provisions of s162, Taxation of Chargeable Gains Act 1992 (TCGA 1992). Briefly, this requires all the assets of the business (with the possible exception of cash) to be transferred as a going concern to the company. The gains arising on the transfer of goodwill, etc, are rolled over, provided the consideration is fully satisfied by the issue of shares in the company.

Alternatively, the 'trading' goodwill could be gifted into the company with the benefit of business asset gift relief under s165, TCGA 1992 or sold to the company for market value at a CGT cost of 20%. Both these options avoid the need to transfer the property to the company, which is not always desirable.

3. Watch out for shareholding 'dilution' issues

One of the key entrepreneurs' relief conditions on share sales requires the shareholder/owner manager to hold at least 5% of the ordinary share capital and 5% of the voting rights throughout the 12 months before the sale. Owner managers would never expect to have any difficulties satisfying this two-pronged test. However, in some cases the main shareholders run into difficulties because they have been diluted by other classes of 'ordinary shares'. Unexpected dilution can also arise in a number of other ways, for example, as a result of the exercise of employee share options.

The definition of 'ordinary share capital' is extremely wide. Broadly speaking all shares will qualify as ordinary share capital unless the shares carry an entitlement to a dividend at a fixed rate (s169S (5), TCGA 1992 and s989, Income Tax Act 2007 (ITA 2007)). The nomenclature of the shares is therefore completely irrelevant. Thus, for example, variable rate preference shares would constitute 'ordinary shares' for entrepreneurs' relief purposes.

Where the company has more than one class of shares, the owner managers/key shareholders should regularly monitor their shareholdings » 38

EXAMPLE 1: THE ER DILUTION PROBLEM

The current issued share capital (showing nominal values) of The Tickling Stick Co Ltd:

	Ordinary shares Voting	A Preferred ordinary shares Non-voting	Variable rate preference shares Non-voting	Voting rights %	Ordinary share capital	Ordinary share capital %
Arthur Doddy	18,000	-	-	39.13%	18,000	3.02%
Anne Yaffle	12,000	-	-	26.09%	12,000	2.01%
Knotty Venture Capital	16,000	50,000	500,000	34.78%	566,000	94.97%
Total	46,000	50,000	500,000	100.00%	596,000	100.00%

All three classes of shares constitute 'ordinary share' capital for entrepreneurs' relief purposes. However, while the founding shareholders have sufficient voting control, they have less than 5% of the ordinary share capital (measured in terms of nominal value). Without corrective action, they would not qualify for entrepreneurs' relief on a future sale of the company.

to ensure they have not been diluted below the critical 5% ordinary share capital/voting rights threshold. An illustrative example of the dilution trap is shown in example 1.

4. Do shares held by a spouse qualify for entrepreneurs' relief?

Sometimes owner managers transfer shares to their spouse to increase the amount of entrepreneurs' relief available on the sale of a company where, for example, they have insufficient entrepreneurs' relief capacity to cover their own expected gain on a future sale.

There is a trap here. Where this is done shortly before a sale, the recipient spouse will not normally have satisfied the 'personal company' requirement throughout the 12 months before the sale. In contrast to a number of other CGT rules, there is 'no stepping into the shoes' of the transferor spouse for entrepreneurs' relief purposes. This means that the recipient spouse will only qualify for entrepreneurs' relief if they have held at least a 5% voting/ordinary share capital holding in their own right in the 12-month period before the sale.

Furthermore, the spouse must also be genuinely employed (which can be on a part-time basis) and/or be director for that period. The case of *Susan Corbett v HMRC [2014] UKFTT 298 (TC)* reminds us that HMRC adopt a strict approach to this requirement.

5. Is there a problem if the company has surplus cash?

For share sales, a competent entrepreneurs' relief claim can only be made if the shares are held in a trading company (or holding company of a trading group) throughout the 12 months before the relevant disposal. Companies often accumulate substantial cash funds, which generally exceed the amount required for working capital and/or future investment purposes. Depending on the precise circumstances of the case, the presence of substantial cash may jeopardise the company's trading status.

In some cases the main shareholders run into difficulties because they have been diluted by other classes of 'ordinary shares'

The 'trading status' condition for entrepreneurs' relief is particularly strict. Broadly, a trading company is only allowed to have non-trading activities if they are not 'substantial'. In this context, HMRC considers 20% to be substantial (s165A, TCGA 1992). In practice, this generally means that the company has to be at least 80% engaged in trading activities.

A number of inheritance tax (IHT) business property relief cases and HMRC guidance show that the following factors should be considered:

- income (such as turnover, investment income, and so on);
- gross assets (remember to include 'goodwill' not on the balance sheet);
- expenses incurred;
- management and employee time spent; and
- company history.

HMRC tends to adopt a pragmatic approach to the treatment of 'surplus cash'. Provided the cash has accumulated from trading activities and has not been actively invested or managed, HMRC does not normally seek to treat it as a non-trading activity. On the other hand, where the cash has been regularly moved to different accounts to get the best return or invested, this is likely to be treated as a non-trading activity. Nevertheless, even this might be insufficient to invalidate the company's trading status, where all the other 'activity' measures are (almost) entirely trade-related. It is difficult to generalise

here since each case is dependent on its own facts. If there is genuine uncertainty about the 'trading company' condition before an expected future sale, it is recommended that an advance non-statutory clearance be obtained from HMRC to confirm the position. It is important that the clearance application fulfills HMRC's prescriptive requirements (see Annex A, HMRC Non-statutory clearance service guidance https://bit.ly/1Qsi7b5).

6. Can entrepreneurs' relief be claimed on loan notes given as consideration for the sale of shares?

Many company share sales involve the purchaser issuing loan notes to the sellers as part of the consideration. Typically, the loan notes will constitute qualifying corporate bonds (QCBs) since they will be 'normal commercial loans', expressed in sterling, and have no option to permit conversion into a foreign currency.

The default position is that the capital gain relating to the loan note consideration is calculated at the time of the share sale, which is then deferred. The CGT relating to the deferred gain subsequently becomes payable when the loan note is repaid. Where the loan note is repayable in instalments, only the tax relating to each repayment is payable.

Unfortunately, since the purchaser is unlikely to be the seller's personal company for entrepreneurs' relief purposes, the repayments of the loan note (security) held in the purchasing company will not qualify for entrepreneurs' relief. Hence, the seller will expect to pay the normal 20% CGT charge on each repayment.

However, it is possible for sellers to claim entrepreneurs' relief on their loan notes provided they are willing to make an election under s169R, TCGA 1992. This election effectively taxes the loan note at the date of the share sale, thus enabling the loan note 'gain' to qualify for entrepreneurs' relief. The election is made on an 'all or nothing' basis – it is not possible to elect for only part of the loan note to be subject for example, to limit the gain to the amount of the seller's available ER capacity). All too often, the ability to make s169R, TCGA 1992 election has been overlooked, with the resultant loss of entrepreneurs' relief. Similar issues arise for non-QCB loan notes.

By making the election, sellers should recognise that the relevant CGT will be paid earlier – sometimes some years before it would be due under the default deferral treatment. Furthermore, there is no mechanism for claiming tax back if all or part of the loan note subsequently becomes irrecoverable (although this is not an issue if the loan notes are backed by a bank guarantee).

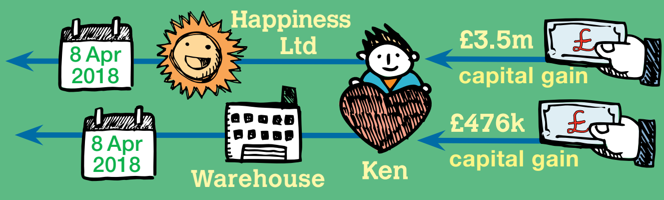
7. Is it possible to obtain entrepreneurs' relief on earn-out payments?

A large number of company sales involve earn-out consideration, where the sellers receive additional deferred consideration that is calculated by reference to a formula based on the post-sale profits or turnover. It is easy to pay unnecessary additional CGT on earn-outs simply due to a failure to recognise the complex way in which earn-outs are taxed.

Provided the earn-out is satisfied in cash (and not shares or loan notes), it should be possible » 40

EXAMPLE 2: ASSOCIATED DISPOSAL ER

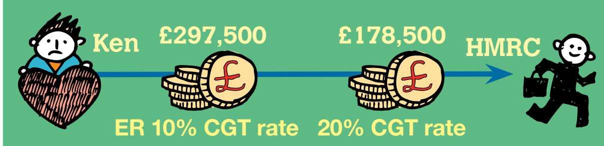
On 8 April 2018, Ken sold his 100% holding in Happiness Ltd and realised a capital gain of some £3.5m. As part of the sale transaction, Ken also sold the freehold warehouse to the buyer realising a capital gain (net of disposal costs) of £476,000.



Ken had acquired the warehouse on 6 April 2002, and it had been used in the company's trade until it was sold on 8 April 2018. He had charged a market rent for the property until 5 April 2010, after which he decided to charge half the market rent.

Ken can claim associated disposal relief on the sale of the property but since he had charged rent to the company, the qualifying gain is calculated on a 'just and reasonable' basis as shown:

	Ownership	Apportioned gain £	Rent restriction	Non-qualifying gain £
06/04/02 to 05/04/08	6	178,500	0%	-
06/04/08 to 05/04/10	2	59,500	100%	59,500
06/04/10 to 08/04/18	8	238,000	50%	119,000
	16	476,000		178,500



Ken's gain eligible for ER associated disposal relief (taxed at the ER 10% CGT rate) is therefore £297,500 (being £476,000 less £178,500). The non-qualifying element would be taxed at the normal 20% rate.

to obtain ER on part of the earn-out. Based on the important ruling in *Marren v Ingles (1980) STC 500*, the value of the right to the earn-out (which is regarded as a 'chose in action') must be taxed as part of the seller's 'up-front' disposal proceeds.

Given the (lifetime) entrepreneurs' relief £10m gains limit, many sellers are likely to have sufficient capacity to obtain the beneficial 10% rate on the initial value of the earn-out taxed (although at that stage, this is an unrealised gain). The valuation of the earn-out right (which must invariably be agreed with HMRC) would need to be robust. It is not possible to use the maximum value of the earn-out consideration. The value tends to be heavily discounted for the contingent and risky nature of the expected earn-out cash flows as well as the time value of money.

Under the *Marren v Ingles* principle, further CGT disposals (under s22, TCGA 1992) are triggered when the actual earn-out payments are received. These are likely to give rise to further gains, which are based on the excess of the actual earn-out payment over the (part disposal) value of the initial value of the right. Strictly, this represents a disposal/part disposal of a right as opposed to shares. Consequently, these earn-out 'gains' do not qualify for entrepreneurs' relief and would be taxed at 20% (assuming the current main CGT rate continues).

Thus, in essence, the seller's entrepreneurs' relief claim would be optimised if the highest legitimate value can be agreed for the original right. Although this is often good advice, there is clearly no benefit where the seller has used up their £10m million entrepreneurs' relief gains limit. If the seller has used up their limit, they may wish to defer the CGT on their earn-out gains. This can be done by restructuring the earn-out so that:

- it can only be satisfied in the form of 'short-dated' loan notes; and
- the seller making a 'deferral' election under s138A, TCGA 1992.

8. Can entrepreneurs' relief be claimed on enterprise management incentives (EMI) shares that are sold on the sale of a company?

The vast majority of enterprise management incentives (EMI) share schemes are 'exit-based'. This means that the employees will exercise their options and acquire their shares shortly before the company is sold. These options enjoy very beneficial treatment. Provided the employees' EMI options are granted at least one year before the sale of their 'EMI' option shares, they will qualify for entrepreneurs' relief in the normal way. In effect, the EMI option holders are deemed to have held their shares while they held the benefit of their option for the purposes of the 12-month ownership rule.

Furthermore, in contrast to all other entrepreneurs' relief claimants, they do not have to hold at least 5% of the ordinary share capital. These generous relaxations are not available to any other type of employee share option.

Other shareholders should take into account the dilutive effect of the EMI options so as to ensure (as far as possible) that their entrepreneurs'

relief will not be prejudiced by the subsequent exercise of (EMI) share options. However, HMRC has confirmed that this adverse dilutive effect on the existing shareholders can only be ignored if (exceptionally) the EMI options are exercised on the same day as the sale of the company.

9. Beware of the 'rent-trap' on the sale of personally owned assets used in the company's trade

Associated disposal relief is a different type of entrepreneurs' relief, which is available on 'personally owned' assets in a number of specific situations. In the case of a share sale, this relief is potentially available on the disposal of such assets that have been used in the company's trade – this will often be the company's trading premises. The relief is only available where the sale of the asset is 'associated' with the share disposal. Section 169K, TCGA 1992 lays down a number of further conditions that must be met. Broadly:

- the shareholder must sell at least a 5% shareholding (effectively creating a 'withdrawal from participation');
- the relevant asset must have been owned for at least three years; and
- the asset must be used in the company's trade throughout the 12-month period before the shares are sold (or the earlier cessation of the trade)

In some cases, the shareholder may have charged rent for the use of the property. They may have been advised to do this as a tax-efficient way of extracting income from the company (since it would not involve any national insurance contributions (NICs)). However, it is often overlooked that the charging of rent can restrict the amount of entrepreneurs' relief that can be claimed on a subsequent disposal of the property. The relief is restricted on a 'just and reasonable' basis according to the level of rent that has been charged by the shareholder and, where appropriate, the period during which the rent has been charged. However, this calculation only takes into account periods after 6 April 2008. A worked example of the 'just and reasonable' restriction due to previous rent charges is shown in example 2.

10. Is it possible to claim entrepreneurs' relief by selling shares to a connected company?

A number of owner managers often ask whether they can sell their shares to a 'connected' company and obtain the benefit of the entrepreneurs' relief. The short answer is 'No – they cannot!'. The long answer would take another long article. Suffice to say that this type of transaction offends the 'transactions in securities provisions' in Part 13, Chapter 1, ITA 2007. HMRC would see this type of transaction as a way of extracting monies from the connected company at a beneficial entrepreneurs' relief CGT rate, which could have been taken as dividends subject to income tax. Broadly, such transactions would be countered by HMRC taxing the 'capital' sale proceeds at penal dividend income tax rates.

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