

Banking of entrepreneurs relief from April 2019

(Lecture P1108 – 11.41 minutes)

An Entrepreneurs' relief dilemma

As mentioned in the previous article, a dilution of shares below 5% at any point in the 12-months before the disposal will lead to a denial of entrepreneurs' relief (ER). Remember this period extends to 24 months for disposals taking place from 6 April 2019.

For example, Ernie has shares in a trading company in which he is a director. Ernie has held the shares since the company was founded. His shareholding is sufficiently large that a disposal of shares will qualify for ER.

The company has been looking for an injection of finance and has located external investors who will subscribe for shares in the company and help it grow. The issue of new shares will mean that Ernie's shareholding will be diluted to less than 5%. Ernie's shares will therefore be taken out of the range of ER and his CGT exposure on a sale of those shares will double.

Ernie would rather retain his investment and stay with the company to help support and grow the business. However he accepts that for CGT reasons he may be better off exiting the company earlier than planned.

Ernie could consider engineering a disposal to crystallise ER while retaining his shares by either:

- Gifting his shares to a settlor-interested trust (which has IHT considerations and is potentially fee-heavy); or
- Selling his shares and buying them back which means a) finding a buyer and then b) waiting 31 days to avoid the impact of the share matching rules which leaves him exposed to share movements in the waiting-period. His wife could buy the shares back sooner, but this still isn't ideal.

Whichever way you look at it, there is no comfortable solution.

This scenario (or something similar) was presented to the Government who responded with the announcement of a consultation under the title "Financing growth in innovative firms: allowing Entrepreneurs' Relief on gains before dilution". The consultation ended in May 2018 and draft legislation followed in July 2018.

The Government agreed with many respondents and accepts that the present rules are a "perverse consequence" of a company becoming successful and wishing to issue more shares. It was recognised that the requirement to satisfy the 5% rule until disposal can act as a disincentive for existing shareholders to accept external investment. In practice this often means that the original entrepreneurs, like Ernie, who founded the company do not benefit from ER because their share interest has been diluted by the time it is their turn to exit.

A very sensible solution

The solution to the problem comes in the form of ER 'banking'.

The draft clauses to the Finance Bill 2018/19 allow ER to be banked in circumstances where an individual loses his entitlement to the relief by reason of his shareholding falling below the 5% threshold.

The individual can make an election that treats his shares as having been disposed of immediately before their eligibility for ER is lost for an amount equal to their market value at that point. The deemed disposal will crystallise a gain that is eligible for ER. [If the deemed disposal would give rise to a loss, no election is possible.]

Having 'sold' the shares, the individual is then treated as having immediately reacquired them at the same value. An unexpectedly generous clause says that the market value of the shares can be based on a percentage of the full value of the company. For example, if Ernie has a 25% holding and the company is worth £2 million, his shares would be deemed to be worth 25% of £2 million. There would be no need to value the 25% holding on a discounted minority basis (as there would be if, for example, the shares were being given away).

This has the benefit of;

- Increasing the amount of the gain which is eligible for ER;
- Reducing future gains which are not eligible for ER; and
- Making the valuation exercise far less painful than it might otherwise have been.

Deferring the deemed gain

The disposal at market value triggers a gain that is eligible for ER. A CGT charge arises. Tax is then due at 10%.

Clearly this is a 'dry' tax charge as the individual does not have any cash proceeds from which to meet the liability.

In this case the individual can make an election to postpone the charge until the shares are sold. The effect of the election is that no gain is treated as having arisen at the time that ER is 'banked'. Instead the notional gain that would have arisen on the deemed disposal is deferred. This deferred gain is crystallised on the date that the shares are sold.

The effect of such an election is that two chargeable gains will arise on an eventual disposal of the shares, these being;

- 1) The deemed gain arising immediately before the relevant share issue. This gain will qualify for ER; and
- 2) The gain arising between the date of the relevant share issue and the sale of the shares (being sales proceeds less the non-discounted value of the shares at the date of the election). This gain will not qualify for ER as the 5% test will not be satisfied.

There is little point adding gains 1) and 2) together as these gains will be taxed at separate CGT rates.

In relation to the gain at 2) above, it is of course possible that the individual will acquire more shares in the intervening period, taking his holding back above 5%. In this case ER would be available on this disposal if a 5% holding has been held for at least 12 months, or 24 months from 6 April 2019.

If only part of the shareholding is sold, only that same part of the deferred gain falls into charge. The rest of the gain continues to be deferred.

Example

Ernie subscribed £50,000 in 2010 for a 25% shareholding (2,500 shares) in Trade Co Ltd. He is a director. On 30 April 2019, Trade Co Ltd issued new shares to external investors such that Ernie's shareholding in the company became diluted to 4%. He made an election under S.169SC TCGA 1992 to be treated as having disposed of his shares immediately before the new shares were issued. The value of Trade Co at that date was agreed to be £2 million.

Ernie also elected under S.169SD TCGA 1992 for the notional gain to be deferred until the sale of his shares in Trade Co Ltd. Ernie sold 1,000 of his Trade Co shares in June 2020 for £300,000.

Show the chargeable gains arising in 2020/21.

Solution

There is a deemed disposal and reacquisition of shares at market value on 30 April 2019 as follows:

		£
MV of 25% shareholding	£2 million x 25% (no discount)	500,000
Less: Base Cost		<u>(50,000)</u>
Notional gain (deferred)		<u>450,000</u>
CGT base cost of 2,500 shares at 30 April 2019		<u>500,000</u>

Sale of 1,000 shares in June 2020:

		£
Sales proceeds		300,000
Less: Base Cost (1,000 shares)	1,000 / 2,500 x £500,000	<u>(200,000)</u>
Chargeable gain		<u>100,000</u>
Deferred gain crystallised June 2020	1,000 / 2,500 x £450,000	<u>180,000</u>

The deferred gain (£180,000) will be eligible for ER. The gain arising on the actual share sale (£100,000) will not qualify for ER because Ernie only has a 4% interest.

Capital losses

Where the sale of the shares gives rise to a capital loss, this loss can be set-off against the crystallised gain on the deemed disposal. This is because the effect of the postponement election is to treat the gain and loss as arising in the same tax year. This is only possible if the deemed gain is deferred. If no postponement election had been made – and CGT was paid in the tax year of the notional disposal – the later loss cannot be carried back against the earlier gain.

Losses on a share disposal could be caused by the shares falling in value between the date of the deemed disposal and the date of sale. However, bear in mind here that the shares have been 'over-valued' on the deemed disposal as no account was taken of discounts for minority holdings. Once ER has been 'banked', the CGT base cost for the shareholding is more than the shares would fetch if sold on the open market at that date. Capital losses on a disposal may not therefore be all that surprising.

The required elections

There are two elections in this scenario:

1. The 'banking election' (author's tag) which triggers the deemed gain at market value. This election must be made no later than the self-assessment filing deadline being 31 January following the tax year in which the deemed disposal takes place; and
2. The 'postponement election' (author's tag again) which defers the gain and effectively drops it into the tax year in which the shares are sold. This election should be made within four years of the end of the tax year of the deemed disposal.

The postponement election can only be made if the banking election has been made (which is somewhat obvious but the draftsman found reason to make this clear). Both elections are irrevocable.

It seems likely that both elections will be made at the same time via the SA return. After all, if a postponement election is not made by the SA filing date, HMRC will expect to receive the tax.

It should also be noted that if a postponement election has been made, when the deferred gain crystallises it will only qualify for ER if a claim is made. This claim should be made within the normal ER time limit which is the anniversary of the 31 January following the tax year in which the gain is charged. In plain English this means that if the client sells his shares in 2020/21, an ER claim in relation to the deferred gain should be made by 31 January 2023.

If shares are sold in bunches so that part of the deferred gain crystallises each time, an ER claim must be made in respect of every gain which becomes chargeable.

The conditions

Not all shareholders can bank their ER entitlements.

A banking election can only be made if the reason for the dilution of the claimant's shares is the issue of new shares by the company. There is no restriction on the type of shares issued by the company (for example, relief is still available if the new shares are not ordinary shares carrying voting rights).

This new share issue must be for cash and (as is standard nowadays), it must be for genuine commercial reasons and must not form part of an arrangement for the avoidance of tax. It seems that the government expects companies to use the new share capital for the purpose of the trade.

Elections to bank ER can only be made where there is a 'relevant share issue' on or after 6 April 2019. Therefore, companies who are currently seeking external investment which would put shareholders in the position where their holdings would be diluted to less than 5%, might want to put their funding plans on hold until April 2019 (or at least get all their ducks in a row now with a view to issuing the shares to their investors on 6 April 2019).

A banking election cannot be made just because a shareholder disposes of some shares and that disposal takes his shareholding below 5%. Shareholders in this position should either retain a 5% shareholding or simply sell the lot.

Finally here I am told that it is not uncommon for Shareholder Agreements to have been drafted so as to prohibit the dilution of certain shareholdings below 5% in order that eligibility for ER is preserved. Presumably clauses to this effect will no longer be necessary after April 2019.

Contributed by Steve Sanders