

Entrepreneurs' Relief On Share Disposals

(Lecture P1107 – 13.18 minutes)

Before we start, somewhat confusingly Entrepreneurs' Relief (ER) is neither a 'relief' nor is it reserved for 'entrepreneurs'.

A claim for ER gives individuals access to a 10% rate of CGT on qualifying gains, up to a lifetime limit of £10 million. ER therefore halves the CGT rate for higher-rate taxpayers.

This means that ER is in fact more of a 'special CGT rate' than a relief (no gains are being 'relieved' here any more – all of them are still chargeable). And the fact that this special CGT rate can be claimed by humble company employees means that it is not exclusively reserved for the go-getting Dragons among us. But I guess the Government has more pressing things on its agenda than a renaming exercise. And we've kinda gotten used to it.

ER can also be claimed by Trustees in certain limited circumstances. ER is not, however, available to companies to reduce the CT rate on corporate gains.

'Qualifying gains' generally means gains on the disposal of either a sole trade business, an interest in a trading partnership or certain shares in trading companies. No ER is available on a transfer of goodwill to a related party (for example on an incorporation) since December 2014. ER is also available on certain "associated disposals", most commonly where an individual disposes of an asset used in the business as part of his withdrawal from that business.

These notes will concern themselves with disposals of shares. This article will discuss ER on share disposals in general and will highlight some practical points and common pitfalls which practitioners should be wary of. The article that follows will cover the changes to ER on share disposals which will be introduced from 6 April 2019.

The ER rules for shares

Historically ER has been available on a disposal of shares where, for a period of at least 12 months prior to the disposal:

- The individual disposing of shares owns at least 5% of the ordinary share capital of the company; and
- The individual disposing of shares is an officer or employee of the company (or another company in the same group); and
- The company is a trading company (or the holding company of a trading group).

ER is not automatic. The taxpayer must submit a formal claim for ER no later than the first anniversary of the 31 January following the tax year in which the disposal takes place (being 31 January 2020 for disposals in 2017/18). In most cases the ER claim is made on the relevant SA return although there is an online "Claim for Entrepreneurs' Relief" form for claims made outside the return. The claim can be amended or revoked within the time limit.

From 6 April 2019, the minimum period that certain conditions must be met is increased from 12 months to two years. However, the 12-month rule remains where the taxpayer's business ceased, or his personal company ceased to be a trading company before 29 October 2019.

The 5% test

Prior to 29 October 2019, the shareholder was required to have at least 5% of the ordinary share capital throughout a period of 12 months immediately prior to disposal. This requires an entitlement to at least 5% of the voting rights. The 5% test is measured by reference to the nominal value of the shares rather than the number of shares in issue (although in many cases this will give the same result).

Shares carrying a right to a fixed-rate dividend will not qualify for ER. Following the McQuillan decision at the UTT in 2017, it has been confirmed that ordinary shares which do not carry dividend rights can qualify for ER as, despite HMRC arguing otherwise, 'nil' is not a fixed-rate. These shares must however carry voting rights.

A dilution of shares below 5% at any point in the qualifying period before the disposal will lead to a denial of ER.

From 29 October 2019, the taxpayer must have at least 5% of the ordinary share capital and voting power but also 5% of the profits on distribution and 5% of the assets on a winding up.

There is a real concern that the requirement to have at least 5% of the profits on distribution will affect companies with alphabet shares. Normal practice is to make sure that dividends on each class are independently declarable. It will be important to check the company's Articles of Association as many allow directors to pay differing dividend rates on different classes of share; indeed shareholders may be guaranteed nothing. It would seem that the 5% distribution test could prove problematic for such companies. Until we receive clarification on this point from HMRC, it would seem prudent to avoid creating alphabet shares where there is real value in the taxpayer's company and so entitlement to entrepreneurs' relief is important.

5% test – additional point

A husband and wife are separate taxpayers for ER and there is no aggregation of holdings for the 5% test. This means that if a husband holds 4% of a company and his wife owns 2%, and both work for the company, neither of them will be entitled to ER on a disposal of their shares. In this case thought should be given to placing all shares in one name by means of an inter-spouse transfer. ER would then be available after 12 months have elapsed.

The same is true for non-married couples although this arrangement is slightly more problematic as the process of transferring the shares between the couple is not CGT and IHT exempt.

In cases where one spouse or partner already has a 5% holding (for example if the husband holds 6% of a company and his wife owns 2% and both work for the company), a transfer of the wife's 2% to the husband would give entitlement to ER on the full 8% straight away.

The 5% test does not apply to disposals of shares acquired under the Enterprise Management Incentive (EMI) Scheme. In this case ER can be claimed irrespective of the size of the holding. In addition, the 12-month qualifying period for EMI shares starts from the date the EMI options were originally granted, so disposals immediately after the exercise of the EMI options will normally qualify for ER.

The 'officer or employee' test

There is no minimum hour stipulation, so full or part-time employees or directors will be eligible.

Where the shareholder claims ER on the basis that he is an employee, it is not uncommon for HMRC to look at PAYE records for the preceding 12 months to check the veracity of this claim. However, there is little to support HMRC's view than an employee needs to receive any payment from the company in order for an ER claim to be substantiated. The Courts have not upheld this view in employment-status cases and have found that individuals acting as employees are still employees even though they received no payment. But there is no point walking the tightrope here. Prudent advice is for employees with 5% or more of the shares to be paid as this ends the argument.

In the case of officers (including directors), simply being an office-holder is sufficient and payment of remuneration is not required. A little care must be taken here if an individual is to be appointed as a Company Secretary because although this role ticks the box as far as being an 'officer' is concerned, some company constitutions have rendered the Co-Sec role obsolete. Where a shareholder is appointed to a role which doesn't exist, it is hard to sustain a claim that he is an officer. Articles should be checked (and if necessary amended) before a Company Secretary is appointed.

What is clear is that the shareholder must remain an officer or employee of the company for the whole of the 12 months up to the disposal. This period increases to 24 months for disposals that take place from 6 April 2019.

The importance of this was highlighted in the FTT case of JK Moore v HMRC (2016). Mr Moore was a director and founder shareholder of a company. After some disagreements with his fellow shareholder-directors it was decided that Mr Moore should resign from the Board. The company agreed to acquire his shares via a buy-back. Mr Moore resigned his directorship in February. The contract for the repurchase of shares was not executed until May. Mr Moore's ER claim was subsequently denied as he had not been an officer or employee for the full 12 months leading up to the disposal.

This was careless but it is easy to see how this could have been overlooked in a case where feelings were perhaps running a little high. In hindsight, arrangements should have been made for Mr Moore to remain as an officer or employee of the company in some capacity until the contracts for the share disposal had been signed. This is not difficult to organise, but it does require somebody to engage in a bit of fore-thought.

The 'trading company' test

According to S.165A TCGA 1992, "a trading company is a company carrying on trading activities whose activities do not include, to a substantial extent, activities other than trading activities".

HMRC guidance tells us that “substantial” means more than 20%. The “20% test” is applied to several different criteria such as turnover, profits, asset base and directors’ time. A holistic view is then taken.

Practitioners need to keep an eye on this because as a company develops and the nature of its business changes, it is feasible for profits to be reinvested in more investment-based activities such as property letting (or simply retained as cash). There might then come a point where the 20% test is tipped in HMRC’s favour which could then lead to a denial of ER on a sale of shares. An annual ‘ER review’ of the company accounts should be within the tax practitioner’s duty of care.

Practitioners should also bear in mind that HMRC’s non-statutory business clearance service (NSBCS) can be used to verify that a company has trading status. This can be helpful where cash balances are high. [See page CG64100 of the HMRC CGT Manual]. This is perhaps the first port of call before a decision is made to reduce the cash mountain by paying a taxable dividend. Clearance under the NSBCS can only be used by the company. Individual shareholders who are anxious to know whether their shares qualify will therefore have to piggy-back on the company’s clearance application.

In companies where letting activities are becoming more prominent (due to good rental returns and capital growth), thought should be given to hiving-out this part of the business into a separate company. This will protect the ER position for the original shares.

There is no territorial restriction on where the trade is carried on (or indeed where the shares are registered). Shares in foreign companies are therefore eligible for ER.

On this point it has been confirmed that where gains on foreign shares have been subject to a remittance basis claim, ER is available to tax the gains at 10% when the proceeds are remitted to the UK. This is however subject to an ER claim being made by the normal time limit. This means that gains made in 2017/18 would need to be accompanied by an ER claim no later than January 2020 even though the gain may not have been remitted by that point.

The sensible course of action here is that if a client makes qualifying gains which are then sheltered by a remittance basis claim, a protective ER claim should also be made “just in case”.

Protective claims should also be considered for individuals making a qualifying share disposal in a non-resident tax year where it is likely that they will resume residence within 5 years of leaving. In this case the gain will be taxed in the year of return under the temporary non-residents rules. ER will only be available if a claim was made within the normal time limit.

The company must be a trading company throughout the 12 months up to the disposal, extended to 24 months from 6 April 2019. This is an interesting rule because it opens-up the possibility for companies whose shares would not be eligible for ER due to the nature of its business, to change that business and trigger eligibility for ER 12 (or 24) months later. This is not always easy to do of course. However, a company with a rental business which switched to letting-out qualifying furnished holiday accommodation would only need to satisfy the FHA criteria for 12 months for the shares to qualify for ER, extended to 24 months from 6 April 2019. The previous non-trading history would be wiped-away.

The need to be a trading company for the qualifying period before the share disposal is relaxed where the company is wound up and the shareholder receives a capital distribution on a disposal of the shares.

In this case ER is available provided that:

- The capital distribution takes place within three years of the cessation of the company's trade; and
- The shareholder had a 5% interest and was an officer or employee of the company for the 12 months (24 months from 6 April 2019) before the company ceased trading.

Practitioners seeking to secure ER on a winding-up should have regard to the "anti-phoenixing" rules introduced with effect from 6 April 2016. These provisions prevent shareholders from winding-up Company A, paying CGT at 10% on the accumulated cash reserves which are paid out as capital, then setting up Company B to do the same thing. In this case the distribution from Company A would be treated as income and taxed at 32.5% or 38.1%.

The lifetime limit

The maximum amount of qualifying gains that may benefit from ER is restricted to a lifetime limit of £10 million. Practitioners should therefore keep a record of the gains against which clients have previously made a claim.

This limit is not index-linked and there seem to be no plans to increase it. The limit is effectively £20 million for a couple, so where qualifying gains exceed £10 million, the opportunity to use both spouse's limits should not be wasted. The potential tax saving here is £1 million that is not to be sniffed at.

Contributed by Steve Sanders