

Entrepreneurs' relief and non-trading

(Lecture P1168 -17.22 minutes)

Given the value of entrepreneurs' relief, there are constant fears that this CGT benefit may be withdrawn on the ground that its expense is becoming too costly for Government. Hopefully, this will not transpire (especially in the light of the changes made by FA 2019), but, while the relief continues, the relevant conditions are being, in the words of one commentator, 'regularly stress-checked by HMRC'.

The recent case of *Potter v HMRC* (2019), which was heard by the First-Tier Tribunal, raises two questions of practical interest in connection with this important relief:

1. When does a diminution or temporary suspension of trading activities fall to be treated as a cessation of those activities?
2. In what circumstances can investment activities lead to a loss of entrepreneurs' relief?

The taxpayer (P) was a shareholder director in a company called Gatebright Ltd (G Ltd) which traded as a broker on the London Metal Exchange. The deals with which G Ltd was involved were complex and could take months to complete. They depended heavily on finance being available. Following the financial crash in 2008, banks withdrew credit lines, there was little credit available elsewhere and no real appetite for risk-taking among P's prospective clients. The volume of trades declined dramatically.

G Ltd was a successful business which had built up retained profits in excess of £1,000,000. In order to safeguard these reserves, P used £800,000 to purchase two six-year investment bonds which matured in November 2015. The capital was locked up over this period, but the bonds paid annual interest of £35,000 which appears to have been distributed to P and his wife (who was also a shareholder) by way of dividend. The remaining £200,000 was kept as working capital for the company. P told the First-Tier Tribunal that he was not doing this in order to 'sit back and live off the income' and he emphasised that what he wanted was to preserve the current position until another trading opportunity arose.

G Ltd's last invoice was issued in March 2009. After that, P kept working his network of contacts to find new business without success, but, after suffering some ill-health and various other misfortunes (including losing his regulatory licences and having his house ransacked by a gang of local youths), he decided to call it a day when he again had to be admitted to hospital in June 2014. G Ltd went into voluntary liquidation in June 2015 and this was completed on 11 November 2015.

HMRC refused to accept that P and his wife were entitled to entrepreneurs' relief for 2015/16 in relation to the CGT liability occasioned by the voluntary liquidation, using the argument that G Ltd was not a trading company during the requisite period.

By virtue of S169I(2)(c) TCGA 1992, a capital distribution made during a winding up can benefit from an entrepreneurs' relief claim, given that this is treated as a disposal of an interest in shares under S122(1) TCGA 1992.

The relief is subject to the various conditions in S169I(7) TCGA 1992 being met.

Prior to FA 2019, these were:

(i) The company must have been a trading company throughout the 12 months prior to the cessation of its trade;

(ii) Throughout the 12-month period before the company ceased to trade, the shareholder receiving the capital distribution must have:

- held 5% or more of the company's ordinary share capital and voting rights; and
- served as an officer or employee of the company.

(iii) The capital distribution must be made within a period of three years following the cessation of trade (note that HMRC have no discretion to extend this time limit).

In other words, in order to satisfy these conditions, G Ltd's trade must not have ceased before 12 November 2012 and the company must have been a trading company for at least 12 months ended on 12 November 2012 (or any later date up to 11 November 2015).

HMRC's contention was that, because G Ltd issued no further invoices after March 2009, it had ceased to be a trading company outside the three-year period referred to above. Accordingly, entrepreneurs' relief was not due.

In this context, a trading company is a company 'carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities' (S165A(3) TCGA 1992). As is well known, 'substantial' has been unilaterally understood by HMRC to mean 'more than 20%'.

One argument is that G Ltd was carrying on trading activities throughout the required 12-month period. The term 'trading activities' is defined in S165A(4) TCGA 1992 as follows:

““Trading activities” means 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; or
- 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.’

The First-Tier Tribunal concluded that, although G Ltd may not actually have been carrying on any trade after it issued that final invoice in March 2009, the company could be considered to be 'preparing to carry on its old trade once the economic environment permitted it'. G Ltd had therefore continued to be a trading company.

Interestingly, the taxpayer's skeleton argument expressed the position slightly differently:

'If the shop is open but nobody buys anything, it does not change its business classification.'

The judge went on to comment on this line of argument:

'That is true up to a point. If there comes a time when it is clear that there is no realistic possibility of the efforts to drum up new business leading to future trading transactions, it can no longer be said that the trading activities are being carried out for the purposes of a trade or for the purposes of a trade that the company is preparing to carry on. At that point, the company must cease to be a trading company.'

Applying these principles to the present case, I am of the view that, in November 2012, matters had not reached that point. It would still be reasonable for (P and his wife) to believe that their continued efforts would ultimately result in new business. They could not have known of the future health problems which would further disrupt the continuity of the negotiations for deals and ultimately cause them to cease their efforts and dissolve the company.'

Given that the First-Tier Tribunal had accepted that G Ltd was still a trading company in November 2012, we must now examine whether it was disqualified from being a trading company because its activities represented – to a greater extent than 20% – activities which were not trading activities. In other words, was G Ltd carrying out substantial investment activities?

HMRC's argument was that, even if G Ltd was carrying out trading activities from the time when the company made the two bond investments (which they denied), most of the assets of the company and virtually all of its income were derived from the bonds. How could this be anything other than substantial?

This line of attack was defused by the First-Tier Tribunal's observation that the CGT legislation focuses on 'activities', i.e.. what the company actually did. The judge said:

'Once the company had put its money into the bonds, it did not, indeed could not, do anything else in relation to them for six years until they matured. There were no investment activities. The company was locked into the bonds during their term and the directors did not do anything in relation to them.'

The conclusion, therefore, was that, when one stands back and looks at the activities of the company as a whole, its activities were entirely trading activities directed at reviving the company's trade and putting it into a position to enable it to take advantage of the gradual improvement in global financial circumstances.

The appeal was allowed: P and his wife were entitled to claim entrepreneurs' relief on the disposal of their respective holdings in G Ltd.

The question of the extent to which investments can deprive a company of its trading status is one which arises not infrequently. The First-Tier Tribunal correctly pointed out that the legislation focuses on 'activities', and not on assets or income. Thus it is the company's 'activities' which must be examined. Of course, some investments require more activity than others. For example, keeping a quoted share investment portfolio under constant review and actively managing it may well amount to a substantial part of the activities of a company which also carries on a trade. However, the decision in *Potter v HMRC* (2019) undoubtedly gives support to the view that a trading company may be able to make a significant long-term passive investment without endangering its trading standing for entrepreneurs' relief purposes.

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