

## **An entrepreneurs' relief rethink**

### **(Lecture P1117 – 20.12 minutes)**

The Chancellor's Budget on 29 October 2018 included two significant announcements in respect of entrepreneurs' relief:

- 1) For disposals of shares taking place on or after 29 October 2018, an individual, as an additional measure, must be entitled to at least 5% of the company's distributable profits and, in a winding up, must have an entitlement to at least 5% of the company's assets; and
- 2) With effect from 6 April 2019, the minimum period throughout which the various qualifying conditions must be satisfied in order for the relief to be available is being doubled from one year to two years.

Remember that, in order for a shareholder to be eligible for entrepreneurs' relief on a disposal prior to the changes detailed in 1)) above, he had to hold at least 5% of the company's ordinary share capital and be able to exercise at least 5% of the voting rights in the company. The new tests require the claimant also to be entitled to (as a minimum) 5% interests in the profits and assets available for distribution to the company's equity holders.

The definition of 'equity holder' in this context is taken from S158 CTA 2010. This definition includes some types of preference share as well as – potentially – certain loans. However, normal commercial loans (as defined in S162 CTA 2010) are ignored along with most bank lending.

The new legislation's main problem spotted by many tax advisers related to companies having share structures which involve more than one class of capital, e.g. 'A', 'B' and 'C' shares (commonly known as alphabet shares). Typically, these shares will rank equally in all respects, except that dividends are often voted unevenly across the different classes. This provides valuable flexibility in distributing profits, especially in the case of private companies that are often quasi-partnerships. However, where the proportion of the dividend paid which is allocated to any particular share class is completely discretionary (and could therefore be anything from zero to 100%), the argument was that it is difficult to see how the holder of, say, the 'A' shares is entitled to any percentage of the profits available for distribution. This, it was said, applies even if, historically, the shareholder has always received at least 5% of the amount distributed.

On 13 November 2018, the accountancy firm BDO published a piece on their website which was somewhat melodramatically entitled 'Entrepreneurs' relief – the death of alphabet shares?'. BDO's conclusion was:

'It therefore appears that, as the legislation is currently drafted, no alphabet shares will be eligible for entrepreneurs' relief, unless the Articles rank all shares *pari passu* or give a right to a proportion of every dividend declared.'

The author of the report then gave the following example in relation to a hypothetical company:

‘Mr A owns 50 ‘A’ ordinary shares and Mr B owns 50 ‘B’ ordinary shares. The shares rank equally in voting power and assets in a winding up. There are no other shareholders.

The Articles permit dividends to be voted independently between the two classes of share.

Following the Budget announcement, it now appears that neither shareholder will qualify for entrepreneurs’ relief, as they have no absolute right to receive at least 5% of the dividends.’

On the assumption that this argument is correct, even if the two shareholders were able to take steps to restore relief, there would be a gap in the qualification period – given that the new rules are already in force – and so the shares would need to be held for another two years before they were again eligible for entrepreneurs’ relief.

Interestingly, when HMRC were approached about this dilemma, they denied that it had been the Government’s intention to attack alphabet share arrangements. However, the CIOT and other professional bodies were quickly in detailed discussions with the authorities over the wording of the proposed legislation and the outcome of this is explained below.

A similar problem was identified where a class of share (for example, share capital issued to a venture capitalist) has a priority right to a dividend. In such a case, although a holder of other ordinary shares may be beneficially entitled to 5% or more of what is left, that may not be 5% of the total profits available for distribution. This could also be the position where a shareholder is entitled to a preferential claim on assets in a winding up.

Other shareholders who could be affected are those whose companies have:

- (i) growth shares; or
- (ii) ratchet share structures; or
- (iii) shares with different nominal values.

In this context, note the helpful technical note on the meaning of ‘ordinary share capital’ which was published by the CIOT on 19 September 2018.

Fortunately, the Government seem to have accepted that the revised legislation was not wholly satisfactory. As a result, on 21 December 2018, they tabled an amendment to the Finance Bill. This amendment adds an alternative test to the CGT definition of ‘personal company’, based on the shareholder’s entitlement to proceeds in the event of a hypothetical sale of the whole company. The question being asked by the new test is whether it is reasonable to suppose that, if the whole of the ordinary share capital of the company were to be sold for its market value on the date of the shareholder’s actual disposal, he would be entitled to at least 5% of the proceeds. If this question can be answered in the affirmative, entrepreneurs’ relief should normally be available.

The latest test does not rely on meeting the 'equity holders' criteria, but is set out as an alternative. Note that the two original tests based on profits available for distribution and assets in a winding up have been retained by the Finance Bill, apparently 'to provide certainty to those with straightforward company structures'. One of the complications that this will cause is that the original tests took effect for 29 October 2018 onwards, whereas the new hypothetical sale test only came into being on 21 December 2018.

This latest amendment should, it is thought, be effective in restoring relief for companies with alphabet share structures, certainly in the common situation of a private company where genuine co-owners use alphabet shares to maintain flexibility in allocating profits on a year-by-year basis without affecting the underlying equity ownership of the company. In other scenarios, especially where venture capital investment is involved, it will still be necessary to take extra care when examining the precise impact of the arrangements in question.

*Contributed by Robert Jamieson*