

## **BADR: Trading and investment activities (Lecture P1298 – 12.05 minutes)**

### *Background*

Business asset disposal relief (BADR) offers individual taxpayers a capital gains tax (CGT) rate of 10% on net chargeable gains up to a lifetime limit of £1 million.

A claim for BADR is available on a material disposal of business assets, such as on a disposal of shares in a company.

### *Is it a 'trading' company?*

For an individual shareholder disposing of shares in a company, the disposal is material for BADR purposes if any of four alternative conditions is met. The most common condition ('Condition A' in the legislation) is that throughout a two-year period ending with the date of disposal, the company is the individual's personal company and is a trading company (or the holding company of a trading group) and that the individual is an officer or employee of the company (or a trading group member, if applicable) (TCGA 1992, s 169I(6)).

A 'trading company' for BADR purposes is defined as a company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities. Unfortunately, the legislation does not provide a definition of 'substantial'. This has caused uncertainty for taxpayers, plus difficulties for HMRC officers faced with the task of establishing whether a company was a trading company for BADR purposes.

### *What is 'substantial'?*

HMRC's published guidance on its interpretation of the meaning of substantial for BADR purposes (at CG64090) states that 'substantial' in this context means more than 20%. However, this begs the question: '20% of what?'.

HMRC's guidance states that some or all the following measures or indicators are among those that may be taken into account in reviewing a particular company's status:

- income from non-trading activities;
- the asset base of the company;
- expenses incurred, or time spent, by officers and employees of the company in undertaking its activities;
- the company's history; and
- balance of indicators.

HMRC points out that these indicators are not individual tests to which a 20% limit applies, and it may be that some indicators point in one direction and others in the opposite direction. The suggested approach is that the relevance of each indicator is weighed up in the context of the case and judged "in the round". This approach follows the Special Commissioner's in the inheritance tax case *Farmer and anor (Executors of Farmer, dec'd) v IRC* [1999] SpC 216.

Of course, HMRC's guidance in the Capital Gains manual does not carry the force of law and is open to challenge. The definition of trading company, and in particular the meaning of 'to a substantial extent' in the legislation, was considered in *Allam v Revenue and Customs*.

#### *Is there an 'activity'?*

In *Allam*, the taxpayer owned all the share capital in a company ('ADL') and was also director of the company. In July 2011, the taxpayer sold the entire share capital of ADL, and reported a capital gain of £4.925 million from the disposal on his self-assessment return for the tax year 2011/12. He claimed entrepreneurs' relief (now BADR) on the disposal and appealed after HMRC refused his claim.

The business of ADL in the relevant period involved property development and property investment. The First-tier Tribunal (FTT) ([2020] UKFTT 216 (TC)) noted that the turnover of ADL in the year ended 31 December 2011 was made up almost entirely of rental income from the properties (and it was inferred that the position in the previous year was very similar). There was no dispute that ADL was carrying on some trading activities. However, many properties were let to produce rental income. This was considered a non-trading activity. The proportion of company income which comprised non-trading rental income, and the proportion of its assets base devoted to properties which were let simply for their rental income, demonstrated that the property investment and rental activities had real importance and could not be ignored. The FTT concluded that those activities were not trading activities and they had to be regarded as 'substantial' in the context of the activities of the company as a whole.

On appeal, there were two grounds for the Upper Tribunal (UT) ([2021] UKUT 291 (TCC)) to consider. The first ground was that the FTT was wrong in law to take into account investment income from "passive activity" in determining whether ADL's activities included non-trading activities to a substantial extent. The UT considered that what amounts to a company's activity is a question of what the company does in commercial terms, and that the holding of investments was an 'activity'.

The taxpayer's second ground of appeal was that in determining whether non-trading activities were substantial, the FTT was wrong to base its conclusions on the relative values of ADL's assets on its balance sheet and to ignore unrealised development value generated by its development activities. However, the UT did not detect any errors in the FTT's approach. The UT dismissed the taxpayer's appeal against HMRC's refusal to allow entrepreneurs' relief.

#### *Points to note*

1. The tribunals did not find a 20% threshold test of 'substantial' to be particularly helpful. The FTT pointed out that there was no sanction in the legislation for the application of a strict numerical threshold. The FTT also found that the words in the phrase "to a substantial extent" should be given their ordinary and natural meaning in the context of the relief, and that 'substantial' should be taken to mean 'of material or real importance' in the context of the activities of the company as a whole.
2. The UT noted that the FTT did not refer to the *Farmer* case and considered that it was correct in not doing so. This would indicate that HMRC's suggested tests for determining how a company's non-trading activities should be measured to assess whether they are 'substantial' need to be approached with caution.
3. The UT referred to another entrepreneurs' relief case, *Potter v Revenue and Customs* [2019] UKFTT 554 (TC). In *Potter*, the company in question was carrying on limited trading activities in the relevant period. Those trading activities had reduced considerably because of the financial crash in

2008/09. Previously, the company had been extremely successful and had substantial cash reserves. It used £800,000 of those reserves to purchase two six-year investment bonds, which paid interest of £35,000 per annum. The FTT held that the company was a trading company and that its activities did not include to a substantial extent activities other than trading activities. The tribunal noted that the investment was tied up for six years and the company did not have to do anything in relation to the investment. As such, it was not an investment activity. The taxpayer's appeal in that case was allowed.

However, the UT in Allam noted that the FTT in Potter seemingly placed considerable weight on the absence of any physical activity in relation to the investment bonds. The UT did not consider that the FTT was right to view the investment bonds as not involving any activity at all. The UT's view was that there would always be some activity involved in such an investment, even if it was only checking that interest was paid each year. In any event, the UT in Allam held that the test was not solely concerned with physical activity.

### *'Surplus' cash*

A common point of uncertainty on the 'substantial' non-trading activities issue is 'surplus cash', i.e., whether the long-term retention of significant earnings generated from trading activities is capable of amounting to an investment activity. HMRC's guidance (at CG64060) states that the first point to consider is whether there is an identifiable activity distinct from the company's trading activity. However, the UT's comments in Allam indicate that the 'activity' test is not reliant solely on the presence or absence of a physical activity.

Some commentators have previously suggested that the retention of accumulated profits in (for example) a non-interest bearing current account of the company would preclude HMRC from arguing that there was an investment activity. Nevertheless, advisers may wish to consider a non-statutory clearance application to HMRC on their clients' behalf with a view to obtaining comfort on this point.

*Contributed by Mark McLaughlin*