

Entrepreneurs' relief case studies

(Lecture P1134 – 17.03 minutes)

S39 and Sch 16 FA 2019 made several important modifications to the entrepreneurs' relief legislation, of which the most controversial were the new 5% 'economic' tests for shares along with the last-minute alternative qualification introduced on 21 December 2018 (see S169S(3)(c) TCGA 1992). The two case studies below illustrate the operation of the new provisions.

Illustration 1

Family Traders Ltd is a successful owner-managed business that has been operating since the early 1990s. The company has two classes of ordinary share capital: 'A' shares and 'B' shares. These shares rank *pari passu* for dividend and voting purposes. The dividends declared on each class of share must be passed by a unanimous resolution of the board of directors. However, on a sale of the company or in the event of a winding up, the 'A' shares carry 97.5% of the capital rights and the 'B' shares carry 2.5% of the capital rights.

The company's share capital has been held for many years as follows:

	<i>£1 'A'</i>	<i>£1 'B'</i>	<i>Total ordinary</i>	<i>% ordinary shares/voting</i>	<i>%</i>
<i>capital</i>					
<i>Shareholders</i>	<i>shares</i>	<i>shares</i>	<i>shares</i>	<i>rights</i>	<i>rights</i>
Andrew	100	–	100	41.7%	54.2%
Ben	80	–	80	33.3%	43.3%
Colin	<u>–</u>	<u>60</u>	<u>60</u>	<u>25.0%</u>	<u>2.5%</u>
Totals	180	60	240	100.0%	100.0%

All three shareholders would have qualified for entrepreneurs' relief on a disposal under the pre-FA 2019 legislation, since they each held at least 5% of the ordinary share capital and voting rights (and had done so for many years).

However, under the FA 2019 regime, only Andrew and Ben will qualify. Each of them will satisfy the critical three tests:

1. the 5% ordinary share capital test;
2. the 5% voting rights test; and
3. the 5% sale proceeds test (using the alternative 'economic' test).

Unfortunately, Colin does not satisfy either of the 'economic' tests in S169S(3)(c) TCGA 1992, given that he is only entitled to 2.5% of the assets on a winding up or 2.5% of the sale proceeds on a sale of the company. Of course, if the capital rights attaching to his 'B' shares were to be increased to, say, 5%, he would begin to accumulate a qualifying entrepreneurs' relief period.

Illustration 2

HIJ Ltd's issued share capital structure has been unaltered for several years:

<i>Shareholders</i>	<i>£1 'A' ordinary shares</i>	<i>£1 ordinary shares</i>	<i>% ordinary shares/voting rights</i>
Private Equity Capital LLP	2,000,000	–	66.7%
Management shareholders			
Harry	–	400,000	13.3%
Ian	–	375,000	12.5%
James	<u>–</u>	<u>225,000</u>	<u>7.5%</u>
	<u>2,000,000</u>	<u>1,000,000</u>	<u>100.0%</u>

Both classes of share capital rank equally in all respects, except that the level of dividend payable on the 'A' ordinary shares and the ordinary shares must be unanimously agreed by the directors. Furthermore, the 'A' ordinary shares are entitled to the first £3,000,000 received on any sale or winding up of the company.

On 1 June 2019, the shareholders sold the entire share capital of HIJ Ltd to a trade buyer for £15,000,000. After taking the 'A' shareholders' prior entitlement into account, the sale proceeds available for allocation to the individual shareholders would be one-third of £12,000,000 (£15,000,000 – £3,000,000), ie. £4,000,000.

The sale proceeds payable to Harry, Ian and James (and their percentages of the total of £15,000,000) would be as follows:

<i>Individual shareholders</i>	<i>% of relevant sale proceeds</i>	<i>Share of sale proceeds</i>	<i>% of full £15,000,000</i>
Harry	13.3%	£1,600,000	10.7%
Ian	12.5%	£1,500,000	10.0%
James	7.5%	£900,000	6.0%
Totals	33.3%	£4,000,000	

This demonstrates that, throughout the two-year period to 1 June 2019, all the individual shareholders satisfied the minimum 5% of total sale proceeds test (based on the £15,000,000 market value of HIJ Ltd at 1 June 2019).

The requirement to use the market value of the company at the end of the qualifying entrepreneurs' relief period is helpful. For example, if HIJ Ltd had only been worth £7,000,000 two years earlier on 1 June 2017, James' share of that would have been £300,000, ie. 4.3%, and that percentage would have been insufficient to attract the relief.

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