A 20 questions guide

How to handle entrepreneurs' relief

Speed read

Entrepreneurs' relief (ER) is available for shares in trading companies provided the conditions in TCGA 1992 ss 169H–169SH are met. ER results in a CGT rate of 10% on lifetime chargeable gains of up to £10m measured on or after 6 April 2008. An individual holding shares in a trading company qualifies for ER in relation to those shares if: the individual is an employee or an officer of the company (or a company within the group where the shares are held in the holding company); the company is a 'personal company' in relation to the individual, and both the employment condition and the shareholding condition are satisfied for the one-year period leading up to the date of disposal of the shares (extended to two years for disposals made on or after 6 April 2019). Recent changes have been made to the personal company requirements and to protect relief for entrepreneurs on dilution of their interests where a business needs additional capital to grow.

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Throughout this article, statutory references are to TCGA 1992 unless otherwise stated and reference to the two year qualification period should be read as the 12 month qualifying period for disposals made prior to 6 April 2019.

1. What are the primary requirements for entrepreneurs' relief (ER) to apply?

The primary requirements for ER qualification are set out at TCGA 1992 Part V and can be summarised as follows:

ER is available to individuals, where capital gains arise from either:

- the 'material disposal' of a business asset;
- the 'material disposal' of a partnership business asset; or
- a disposal 'associated with' a 'material disposal' (see question 17).

ER can also apply on the disposal of trust assets in certain situations (see question 3).

The business assets in question must have been held for a minimum qualifying period of at least two years and relief must be claimed no later than 31 January following the tax year of the relevant disposal. However, ER is subject to a maximum lifetime limit of £10m, calculated on a cumulative basis.

There are no specific territoriality requirements for ER and relief can apply to the disposal of an overseas business by a UK resident individual if the other qualifying requirements are met.

2. What is a 'material disposal' of business assets?

A material disposal of business assets (described in s 169I(2)) takes place where there is either:

a) a disposal of the whole or part of a business;
b) a disposal of (or of interests in) one or more assets in use, at the time at which a business ceases to be carried on, for the purposes of the business; or
c) a disposal of one or more assets consisting of shares in or securities of a company (or of interests in the shares/securities).

3. How does ER apply to sole trade and trading partnership businesses (and trustees)?

Sole traders

Gains on the disposal of business assets owned by sole traders qualify for relief if the assets fall within one of the first two categories in s 169I(2).

A disposal of a CGT asset used in a sole trade will fall within category (a) (in question 2) above if the asset disposed of is identifiable as a separate business or part of a business in its own right, as distinct from an asset that is used in the business. An asset merely used in the business may instead fall within category (b), but the circumstances in which relief is available are more restrictive (see further below). The business (or part thereof) must have been owned by the individual throughout the 24 month qualifying period prior to sale.

Over the years, the courts have considered a number of cases (prior to the introduction of ER, similar questions arose in the context of CGT retirement relief claims) where the distinction between an asset which can be identified as 'part of a business' and an asset which is simply used by the business has been disputed.

The courts have found, for example, that a disposal by a mixed farm business of part of its farmland was not the disposal of a distinct part of the farm business in question (*McGregor v Adcock* [1977] STC 206). On the other hand, the sale of a milk parlour and yard and other business assets by a dairy farmer who retained the remainder of his farmland was found to be the disposal of a distinct part of his business (*Jarmin v Rawlings* [1994] STC 1005).

In practice, each case turns on its particular facts and there is detailed guidance in HMRC's *Capital Gains Manual* at CG64010–CG64035, which may assist where the position is unclear.

Furnished holiday lettings (FHL) businesses present

particular problems. An FHL business is deemed to be a trade for ER purposes under the special rule at s 241(3A) and ER is potentially available on the disposal of a single property FHL business. Where the business comprises more than one FHL property, HMRC may argue that the sale of a single FHL out of a continuing multi-property FHL business does not meet the requirements of category (a).

The disposal of a CGT asset used in a sole trade business will fall within category (b) if all three of the following conditions are met:

- the asset is in use at the time that the business ceases to be carried on;
- the asset has been owned by the individual throughout the 24 month qualifying period (subject to a transitional rule where the business ceased to trade prior to 29 October 2018), ending with the cessation of the business; and
- the asset is disposed of within 36 months after the date of cessation of the business.

Trading partnerships

With regard to trading partnerships, the partnership 'business' is treated as being carried on by each individual partner who is at that time a member of the partnership. ER will apply to the disposals of the partner's interests in partnership business assets which fall within either category (a) or category (b). The partner's share of the gain on disposal of investment assets, such as shares held by the partnership, would not qualify for ER. Relief may be due if the partnership disposes of shares in a trading company but only if the company in question is the disposing partner's personal company (see question 6) and he is an officer or employee of that company.

ER can also apply to:

- the disposal of assets used for the purposes of a business carried on by an individual on entering into a partnership which is to carry on the business; and
- the disposal of the whole or part of an individual's interest in the assets of the trading partnership.

ER can apply to trust-owned business assets but only in limited circumstances

Trust-owned businesses

ER can apply to trust-owned business assets but only in limited circumstances. An ER qualifying disposal of trust business assets takes place where the trust disposes of 'qualifying business assets' *and* there is an individual who is a 'qualifying beneficiary' in relation to that trust.

Qualifying business assets in relation to a trust are either assets of a trading business operated by the trust falling within category (a) or (b) above or are shares or securities in the qualifying beneficiary's 'personal company' (as defined under question 5 below). Note that the requirement for the qualifying beneficiary to also hold shares personally is often overlooked.

A 'qualifying beneficiary' is an individual who throughout the qualifying period holds an interest in possession in the trust. (The £10m lifetime limit of the qualifying beneficiary is applicable to the ER gain and, in strictness, the beneficiary's permission would be required for the trust to utilise part of his or her lifetime allowance.)

4. When does ER apply on incorporation?

In principle, ER can apply to gains on the transfer of business assets on the incorporation of a sole trade or partnership into a limited company (assuming CGT relief is not available under either ss 162 or 165).

With effect from 3 December 2014, ER is not available on gains arising on the transfer of goodwill to a close company where the vendor meets any of the 'personal company' conditions in the acquiring company or a company in its corporate group.

The 'personal company' conditions for this purpose have mirrored the provisions elsewhere in the legislation. The scope of its application to the goodwill restriction was accordingly narrowed with effect from 29 October 2018, and amended again for disposals on or after 21 December 2018 to reflect the extended 'personal company' requirements (see question 6).

The relevant legislation at s 169LA includes an anti-avoidance provision to block arrangements designed to side-step the restriction; for example, where there are arrangements in place for the vendor of the goodwill to acquire an interest in the purchasing company at a later date.

However, there is a relaxation to the restriction: it will not apply in a situation where the shareholder sells his shares to a third party company within 28 days of the incorporation of his business.

For the purposes of the 24 month qualifying period, an amendment to the rules introduced in FA 2019 permits the pre-incorporation period during which the individual carried on the business to be taken into account on the disposal of shares on or after 6 April 2019.

5. What are the requirements for ER to apply on a disposal of shares?

For ER to apply to a disposal of most shares (i.e. shares that do not qualify under the special rules for the enterprise management incentive (see question 11)), the key conditions are that throughout a period of two years:

- the company is the shareholder's 'personal company';
- the company is a 'trading company' or the 'holding company of a trading group'; and
- the shareholder is an officer or employee of the company or another member of the trading group.

Usually the qualifying period is to the date of disposal but, where the company has ceased to trade without continuing as a member of a trading group, the two year qualification period will end on the date the trade ceases. It is also then necessary for the disposal of shares to be within three years of the cessation of trade.

6. What is a personal company?

To qualify for ER on shares, an individual must have been an officer or employee of a 'personal company' throughout the two year qualifying period. Historically, to be a personal company it was necessary for the individual to:

(i) hold at least 5% of the ordinary share capital; and
(ii) be able to exercise at least 5% of the votes.

FA 2019 introduced two additional tests, at least one of which must also apply:

(iii) the individual must be beneficially entitled to at least 5% of the profits available for distribution to 'equity holders', and at least 5% of the assets available on a winding up; or

(iv) in the event of a sale of the whole of the ordinary share capital of the company, the individual would have been entitled to at least 5% of the proceeds.

For test (iv), it is to be assumed that the notional sale of the whole business was for consideration equal to the market value on the last day of the qualifying period.

Test (iv) was added to FA 2019 as it passed through Parliament, following representations to HMRC (including from the authors) that, as originally written, the Finance Bill was overly complicated and would deny ER in circumstances beyond those at which the policy was directed; for example, for companies with 'alphabet' shares. The problem largely arose from the use of the definition of 'equity holders', which derived from the legislation on corporate tax groups and was neither fit for purpose nor terribly clear when applied in the context of a claim for ER. The addition was welcome and is likely to simplify claims for relief in many cases where there are multiple classes of shares or other securities.

7. How is 'ordinary share capital' defined?

Statute defines ordinary share capital as:

> 'all the company's issued share capital (however described), other than capital the holders of which have a right to a dividend at a fixed rate but have no other right to share in the company's profits'.

As evidenced by the number of cases that continue to go to tribunal, 'ordinary share capital' is not a straightforward definition

As evidenced by the number of cases that continue to go to tribunal, this is not a straightforward definition. For example, the case of *S Warshaw v HMRC* [2019] UKFTT 268 considered whether preference shares could constitute ordinary share capital in specific circumstances. Note that HMRC has recently updated its guidance on the meaning of ordinary share capital (see HMRC's *Company Taxation Manual* at CTM00509–CTM00516). This includes a table dealing with types of preference shares, distinguishing which might be ordinary share capital and which are not.

The practical concern with this uncertainty is that if preference shares are taken into account as ordinary share capital in calculating the 5% tests (notwithstanding that they frequently function, and are accounted for, as debt), this may dilute many shareholders below 5%, particularly where a company has external investors.

8. How is a trading company defined?

For ER to apply on a disposal of shares in a single company, it must be trading. Trade has its usual meaning, so it will be necessary to consider such things as the badges of trade, view to a profit, composite trades, etc. Property development and property dealing are capable of being considered as trades for ER purposes.

However, for ER purposes, it is also necessary that the company does not have substantial non-trading activities. There is no statutory definition of 'substantial' but HMRC interprets it as meaning roughly 20% or more when considering the following 'in the round':

- income from the non-trading activity;
- asset base of the non-trading activity; and
- expenses incurred and management/employee time on the activity.

These tests are applied over the whole statutory share ownership period (now two years), but the company's history may allow for a period longer than the usual two year qualifying period to be considered (e.g. where there are long term fluctuations in trade and cash balances).

HMRC will usually accept that cash simply left in the bank is not an 'activity', so not a 'non-trading activity'. However, any action to invest the cash, even in gilts, is likely to be considered investment activity and, therefore, could potentially cause ER to be denied. That said, if a company temporarily invests surplus funds that it requires for trade purposes, HMRC will accept that to be part of its trading activity if sufficient proof of the trading need is available.

9. What is the position for shares held in a corporate group?

As an investment in subsidiaries is considered a non-trading activity, it is unlikely that a holding company will qualify as a trading company in its own right. However, the company will often still qualify for ER on the basis of being the 'holding company of a trading group'.

A group for this purpose includes any subsidiary in which the holding company has a 51% direct or indirect interest. The trading test is applied across the group of companies as a whole.

10. How about companies with joint venture structures?

Where a company holds an interest in a joint venture of 50% or less, it may still qualify for ER under Sch 7ZA (introduced by FA 2016 but with retrospective application to disposals on or after 18 March 2015).

Where a company holds shares in a joint venture company (JVC), by definition the JVC cannot be a member of a group, and the shares in the JVC will be considered a non-trading activity of the investing company/group. However, the JVC interest can be considered a trading activity in respect of a particular shareholder if they hold an effective 5% interest in the underlying JVC. For example, if a company owns 50% of the ordinary share capital and votes in a JVC, the shareholder must themselves hold at least 10% of the ordinary share capital and votes of that company to have an effective 5% interest in the JVC.

The rules are similar in respect of a company which is a corporate partner (or member of an LLP). Although the trade of a partnership or LLP is, for general tax purposes, considered to be carried on by its partners, this does not apply for ER purposes. Instead, the interest of the partnership is considered to be non-trading activities, even if the partnership is itself trading. However, again they can be considered trading activities in respect of a particular shareholder if they hold an effective interest in the partnership's assets, profits and votes.

If the shareholder also holds a direct interest in the underlying JVC or partnership, their direct interest will also be taken into account when considering if they meet the 5% effective ownership tests.

11. What is the position for enterprise management incentive options and shares?

Where an employee sells shares that were acquired through an enterprise management incentive (EMI) option agreement, ER will be available providing the period between grant of the EMI options and the sale of the shares is at least two years.

For EMI shares, it is not necessary for the company to be the shareholder's personal company, so there is no requirement to have a 5% interest in its votes, ordinary share capital or economic value.

Where option holders exercise within 90 days of cessation of employment, the two year period is applied to the date of cessation so leavers may still benefit from ER.

12. How do the new dilution rules work?

FA 2019 introduced new provisions aimed at preventing the situation where a company might avoid seeking further investment in fear of diluting shareholder interests to below 5%, resulting in a loss of ER to the shareholders.

The new dilution rules apply when there is a qualifying 'dilution event'; i.e. an issue of new shares by the company after 6 April 2019. If, as a result of a dilution event, the shareholders find that their shareholding falls below 5%, they may make two elections:

Election 1

This deems there to be a market value disposal and immediate repurchase of shares and securities in the company, crystallising a gain that qualifies for ER, and increasing the base cost of the shares to the then market value. (Market value for this purpose is an apportionment of the value of the whole company without minority discount.)

Election 2

This defers the payment of the tax, arising from election 1, until there is an actual disposal of the shares. The company is deemed to be the individual's personal company for the period of two years immediately prior to the disposal, but the other tests (i.e. an employment or office and the trading status of the company) must also have been met, as a matter of fact, during the relevant period.

13. What has been the practical impact of the FA 2019 changes for main shareholders?

For the main shareholders of a company, the FA 2019 amendments may, in practice, have little effect. This is not unsurprising, given that the policies behind the changes were not targeting them.

Major shareholders will usually hold their shares for much longer than the new two year qualifying period, and the new dilution rules are likely to be of most benefit only to minority shareholders with interests already close to the 5% threshold.

With the first draft of the Finance Bill, there had been a fear that the mere existence of alphabet shares could deny ER but (due, in particular, to the discretionary nature of the dividend rights) with the addition of the second new personal company test, that is no longer the case.

14. What has been the practical impact of the FA 2019 changes for employee shares?

Employee shares are more likely to have performance-related features, which have the effect of varying the rights or values of the shares over time according to certain agreed targets.

Although initial concerns over the new legislation were mitigated by the introduction of test (d) (see question 6), there remain implications for certain types of employee share arrangements.

For example, 'growth' shares, 'flowering' shares or 'ratchets' are now less likely to qualify for ER. For such shares, it will now be necessary for them to have become 'in the money' at or before the date of disposal. Often this will be directly related to the company achieving a certain valuation. Where such shares have attained sufficient value at the disposal date that would enable the individual to meet test (d), the new rules helpfully deem the company value to have applied throughout the two year holding period.

However, if the performance target is based on something other than company value, for example dependent on the company's earnings or revenue from particular sources, the position is less generous. Even though such targets may have been met by the date of disposal, there is no provision to deem such conditions to have been met for the whole of the two year holding period (i.e. projected back). It will, therefore, be much more onerous to satisfy the conditions. Where targets relate to an internal rate of return (as is common for private equity backed companies), this also does not benefit from a backwards-looking deeming rule, although the mechanics of calculating rates of return mean that if it is satisfied at the date of sale, it may well also have been satisfied in earlier periods.

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There can be further complications for shareholders, depending on where specific rights and restrictions in relation to their shareholding are set out. For example, these may be set out in either the company's articles or in a shareholder agreement. However, HMRC's guidance suggests that rights and conditions set out in shareholder agreements are taken into account for some of the tests applied for ER purposes, but not all of them.

Where individuals are relying on such employee share arrangements to qualify for ER, the changes may therefore have a disproportionate impact.

15. What points need to be considered on a share sale?

Firstly, it is important to appreciate that if the personal company test has been passed for the required two year qualifying period, then the disposal of any shares and securities (and interests in shares and securities) in that

company will qualify for ER. ER is not restricted to just those shares that were considered for the personal company test. In practice, this means that, providing the company is considered a personal company, ER will be extended to preference shares, loan notes, shares acquired under options and any other part of the ordinary shareholding that has not been held for two years. Note that shares or securities held in other companies within the group would not qualify for relief unless the other company was also an individual's 'personal company' in its own right.

On the disposal of shares, ER operates differently depending on the nature of the consideration received. The following all assumes that the ER qualification conditions have been met:

- Where cash is received on the completion date, ER will apply to the disposal.
- If shares are received in consideration then, under the operation of s 135, no gain is realised on the exchange of shares and the new shares 'stand in the shoes of' the old shares. HMRC has confirmed that the ER holding period can continue to apply uninterrupted for the new shares. If, on a subsequent disposal of the new shares, the qualifying period straddles the exchange of shares, it is necessary to consider whether the old shares qualified before and the new shares qualified after the exchange. Providing both periods meet the qualifying conditions, ER will apply to the sale of the new shares. An election can be made under s 169Q to disregard the operation of s 135, resulting in the exchange being a chargeable event for which ER would be available. This is likely to be considered by taxpayers if their old shares would have qualified for ER but their new shares would not.
- The above principle also applies if consideration is received in the form of a non-qualifying corporate bond. However, in order for the post-exchange period to qualify for ER, the seller would usually also need to have received some ordinary shares in order to meet the personal company test. It is, therefore, common to see s 169Q elections in such situations. In many private equity backed companies, shareholders will hold ordinary shares in a 'topco' and loan notes in a subsidiary ('bidco'). Any gains rolled into the bidco loan notes would not qualify for ER in these circumstances.
- Where QCBs are received, the gain attributable to the QCB consideration is 'held-over'; i.e. it does not become chargeable until the subsequent disposal of the QCBs. ER will apply when the deferred gain is crystallised only if the conditions are satisfied at that later date.
- If consideration is deferred, then it is necessary to consider whether the earn-out is ascertainable or unascertainable.

Ascertainable consideration will be included in the original gains computation arising when the sale contract became unconditional. ER will, therefore, apply to that deferred consideration.

For unascertainable consideration, it is necessary to value the 'chose in action'; i.e. the right to receive the earn-out at the time of the disposal. That value is included in the original gains computation and ER will be available on the overall gain. However, the chose in action itself is neither a share or security, nor an interest in shares or security, so ER cannot apply to any subsequent gain arising when the earn-out is settled.

16. In what circumstances does ER apply when a trading company is liquidated?

When a company is wound up, it is firstly necessary to consider whether the anti-phoenixing provisions in ITTOIA 2005 s 396B (or ITTOIA 2005 s 404A for non-resident companies) applies to the liquidation distributions. If they do, the distributions will be subject to income tax and ER will, therefore, be irrelevant. Furthermore, liquidations are also within the strict definition of 'transactions in securities' and, therefore, HMRC could issue counteraction notices to effectively assess the gain to income tax if the liquidation was carried out to avoid tax.

The act of winding up a company necessitates that it ceases to trade, whether this occurs when the liquidator is appointed or at some prior date. For ER purposes, the qualifying conditions must be met throughout the two years ending on the date the company ceases to trade. Furthermore, the liquidation distributions must be made by the liquidator within three years of the cessation of trade.

17. What is an associated disposal?

An individual can claim ER in respect of an asset (for example, a property) used by their partnership business or personal company but held outside the business as an 'associated disposal' if:

- they make a 'material' (at least 5%) disposal of the whole or part of their interest in the assets of a partnership or of shares in, or securities of, a company which qualifies for relief (see question 2);
- that material disposal is made as part of the withdrawal of the individual from participation in a business carried on by the partnership or by the company (or by a group company); and
- the associated asset disposed of is used in the business throughout the two year qualifying period ending with the earlier of the date of the material disposal and the cessation of the business of the partnership or company.

[In certain circumstances] an individual can claim ER in respect of an asset used by their partnership business or personal company but held outside the business as an 'associated disposal'

HMRC's interpretation of the legislation is that the associated disposal (e.g. of the property) and the material disposal should be 'part and parcel' of 'one single withdrawal' from the business. It is accepted that there may be some interval between the two transactions and HMRC cites examples (at CG63998) where it considers that the 'associated disposal' and 'material disposal' constitute a single withdrawal. The examples cited are where the 'associated disposal' takes place:

- within one year of the cessation of a business (note the trigger date is the cessation of the business rather than the date of the material disposal);
- within three years of the cessation of a business, and the asset has not been leased or used for any other purpose at any time after the business ceased; and
- where the business has not ceased within three years

of the material disposal, provided that the asset has not been used for any purpose other than that of the business.

It can be seen from the examples cited by HMRC that its expectation is for the material disposal to take place at the same time or slightly before the associated disposal. That said, there is no requirement in the underlying legislation that the material disposal must predate the associated disposal and, indeed, the HMRC commentary does not specify this. It is, however, reasonable to conclude that HMRC will not readily accept that there is an associated disposal where the asset sale precedes the cessation of the trade unless there are compelling underlying facts that support the contention.

'Withdrawal' from participation in the business does not require a reduction of the amount of work that the individual undertakes for the business. It is sufficient that there is a disposal of at least 5% of their interest in the assets or share capital. There is anti-avoidance legislation that will apply if there are arrangements in place for a reacquisition of the assets disposed of as part of the material disposal.

18. What are the restrictions to ER where there is an associated disposal?

Relief for an associated disposal is restricted if the asset has not been used for business purposes throughout the period of ownership if:

- only part of the asset was been used for business purposes;
- the individual was involved in the business for only part of the period of business use; or
- rent was paid by the business for use of the asset. (This restriction does not apply to rental periods prior to 6 April 2008.)

Similarly, a restriction may also apply for any period where an asset is not used in the business, or is used in the business after the individual has withdrawn from it.

The restriction is calculated on a 'just and reasonable' basis. The just and reasonable adjustment is determined by establishing the period of ownership and then identifying any periods where ER is applicable. That fraction of the gain qualifies for ER.

Example

Muggle acquired the trading premises of his sole trade on 1 April 2003. He incorporates the sole trade into a limited company on 1 April 2006 but keeps the property in his own name. He charges the company a full commercial rent for use of the property from 1 April 2006 but, due to the declining fortunes of the business, he reduces the rent to 50% of the commercial rate from 1 April 2016 and then ceases to charge a rent from 1 April 2018. He sells his company shares and the property to a willing buyer on 31 March 2019 realising a gain of £200,000 on the property.

The full period of ownership of the property is 16 years. The ER qualifying periods are:

1 Apr 2003 – 5 Apr 2008*: 60 months (rounded for convenience)

1 Apr 2016 – 31 Mar 2018: 24 months (50% relief available)

1 Apr 2018 – 31 Mar 2019: 12 months

(*For the period from 1 April 2003 and 31 March 2006, the property was a qualifying business asset of Muggle's sole trade. For the period from 1 April 2006 to 5 April 2008, there is no restriction even though a commercial rent was charged.)

The qualifying ER fraction is:

[60 + (24 x 50%) + 12 = 84] ÷ [16 x 12 = 192].

Therefore, 43.75% of the gain of £200,000 would qualify for ER: (84/192 x £200,000 = £87,500).

19. How does ER interact with EIS deferral relief and capital losses?

Clients who have made an enterprise investment scheme (EIS) investment may be tempted to defer a gain for which ER applies, despite the potential risk that a change in government could lead to the withdrawal of ER relief. For gains realised after 3 December 2014, ER can still apply when the gain comes back into charge on disposal of the underlying EIS investment. However, the legislation is complex, and some commentators have raised concerns that in some circumstances ER may be denied for the deferred gain crystallised.

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Where an ER qualifying gain is partly relieved by capital losses or the annual allowance, the relieved element of the gain should not reduce the lifetime allowance. The lifetime allowance is only used up to the extent a qualifying disposal was charged at the 10% rate of tax.

20. What is the interaction with investors' relief?

Investors' relief (IR) is a similar relief to ER, although it only applies to a disposal of shares. The qualification requirement for companies are similar, so it is possible for some shareholders to be eligible for ER and others for IR in respect of a disposal of shares in the same company. However, one condition for IR is that neither the investor, nor a person connected to them, is a relevant employee of the company. Therefore, a person failing to qualify for ER solely as a result of not holding 5% of the shares is likely also not to qualify for IR as a result of being a relevant employee. ('Relevant employee' is widely defined, but may not include an unpaid director in certain circumstances). ■

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