The secret to getting Entrepreneurs’ and Investors’ Relief right

Personal tax | Tax voice

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It’s surprisingly easy to get caught out by Entrepreneurs’ and Investors’ Relief. Here David Marcussen explains the dangers – and how to avoid them.

It’s true. When Richard Branson decided to start a business, it wasn’t so he could claim £10 million of Entrepreneurs’ Relief when he sold it 10 years later. People don’t become entrepreneurs just so they can claim Entrepreneurs’ Relief.

But if an entrepreneur loses a million pounds of tax relief simply because you forgot a small detail along the way, they'll care about Entrepreneurs' Relief. Believe me.

You don't want to slip up with these reliefs, because it can cost someone a great deal of money. And it's really simple to do, despite (or maybe because of) the fact that so many advisers see these reliefs as easy.

The truth is, we need to be thinking and advising our clients about Entrepreneurs' Relief and Investors' Relief right from day one.

How it works: top line overview

Entrepreneurs' Relief:

- 10% CGT rate on disposal of qualifying assets
    - whole or part of a sole trade or partnerships
    - assets used in a business; or
    - shares in a trading company
- £10m lifetime limit per individual
- The individual, if selling shares, needs to fulfil all the following:
    - be a director / employee up to the date of disposal
    - own 5% of share capital – note this is based on the nominal value, rather than simple number of shares
    - be entitled to 5% of voting rights
- 1 year holding period and employment / directorship required to qualify
- Where shares are sold, the company must be a trading company (or holding company of a trading group)
- Shares acquired by exercising qualifying EMI share options don't need to meet the 5% rule above

Investors' Relief:

- 10% CGT rate on disposal of qualifying assets
- £10m lifetime limit
- 3 year holding period required to qualify
- Only available to newly issued shares, issued after 17 March 2016
- An investor can't be an employee or director of the company whilst owning the shares, although these rules are relaxed somewhat for unremunerated

directors or someone who becomes an employee in the future

The more observant among you who read my previous article will see the similarities between Investors' Relief and EIS, which is planned to end when the sunset clause comes into effect in April 2025. Perhaps Investors' Relief was deliberately introduced to take over from EIS?

It's still early days for Investors' Relief, so we'll need to see how well used it is in the future. Entrepreneurs' Relief certainly seems to have been popular, with 52,000 tax payers claiming ER on £25bn of capital gains in 2015/16 (HMRC statistics).

Where things have changed

FA 2014 and 2015 goodwill changes

New rules from 3 December 2014 prevented sole traders and partnerships disposing of their businesses to a company in which they have 5% or more of the ordinary share capital and voting rights and claiming Entrepreneurs' Relief. A further hurdle to work around is a tax advantage anti-avoidance clause (TCGA 1992, s 169LA(6), (7)).

These changes were designed to prevent the classic incorporation planning.

Joint ventures / management companies

Historically, there were ways to spread the ownership of a company wider than, say, 20 people owning 5% – so they all qualified for Entrepreneurs' Relief.

But from 18 March 2018 a shareholder must satisfy the 5% share capital / voting tests directly or indirectly. For example, if someone owns 40% of a company, which in turn holds 30% of the shares and voting rights in the joint venture company, then they indirectly hold 12% of the joint venture company (30% x 40%).

Similar rules were introduced for partnerships.

DOTAS

Since February 2016 the DOTAS – Financial Products Hallmark 9 now applies to shares or securities in a company, which means great care is needed if "special"

classes of shares are used to provide “enhanced” rights to share capital or voting for Entrepreneurs’ Relief purposes. In fact HMRC guidance is so clear that it’s probably better to just avoid this altogether now (although not all consultancies seem to feel the same).

Tax cases – meaning of ordinary shares

A number of recent tax cases impact on what is included in the ordinary share capital pool when working out the 5%. Again, if there are different classes of shares, great care is needed. In this regard it is worth noting that further guidance, albeit in the context of Entrepreneurs relief, has become available through the Capital Taxes Liaison Group – see News Service for CTAs 28 September 2018).

Crystallising gains

From 5 April 2019, shareholders who are about to be diluted below the 5% by a new share issue can choose to protect their Entrepreneurs’ Relief at that point. Effectively they sell and then buy their shareholding straight back, and can claim Entrepreneurs’ Relief on the gain from the sale. Note though that the share issue needs to be for pure commercial reasons.

Where to be smart

Beware different share classes!

It’s not uncommon for private companies to have different share classes. The founders may have one class, the employees another and the external investors a third.

The “5% of the share capital test” for Entrepreneurs’ Relief looks at the nominal value of the shares, so a £1.00 Ordinary Share is worth 100 £0.01 A Ordinary Shares. This can cause significant problems for founders who own the £0.01 A Ordinary Shares where they’re unintentionally diluted below 5% by the issue of £1.00 Ordinary Shares.

Similar problems can occur if there are voting and non-voting shares.

HMRC take a very strict line on this, so if there are different share classes then this needs to be reviewed and any errors corrected more than 12 months before a disposal.

Cash rich companies

Even if the company appears to be “cash-rich”, it may still be considered a trading company for Entrepreneurs’ Relief.

The general view is that if more than 20% of the assets are surplus cash then the company may not be “a company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities”.

The term “substantial extent” isn’t actually defined, but HMRC considers substantial to be “more than 20%” – so at least 80% of the activities must be trading activities.

But it all depends on the underlying facts. For example, a company may be retaining significant funds to allow it to purchase business premises, and this shouldn’t restrict the relief.

Careful with employee share options

When it comes to selling a company, there’s a serious risk that employees exercising their share options can dilute a shareholder below 5% for Entrepreneurs’ Relief. The only way around this is to make sure the share options are exercised on the day of sale. Not the day before. And the simplest solution is to make sure options are exercised as the very last thing that gets done before the sale goes through.

EMI share options

Shares acquired from the exercise of EMI options don’t need to satisfy the 5% rule to qualify for Entrepreneurs’ Relief. So an employee who was going to be issued with a 1% shareholding might instead be awarded a 1% EMI option. The capital gains will then be charged to CGT at 10%, rather than 20%.

However, don’t forget the other rules. The individual still needs to be an employee / director for the 12 months before the disposal of the shares, so if they leave the company they will no longer be entitled to the 10% CGT rate.

Spouses / civil partners have £10m as well

If an individual might exceed the £10m lifetime limit for Entrepreneurs' Relief, they can gift shares to spouses / civil partners to use their £10m lifetime limit as well. Be careful to ensure that the donee qualifies (ie they are an employee / director and satisfy the 12 months rule) – and also that the gift is unconditional.

Consider both Entrepreneurs' Relief and Investors' Relief for the same client

It's possible for someone who is an unpaid director or shareholder in a company to satisfy both the Entrepreneurs' Relief and Investors' Relief qualifying criteria. For clients who are likely to exhaust the £10m Entrepreneurs' Relief (or Investors' Relief) limits, it's worth structuring their investments to qualify for both reliefs if you can – giving them the opportunity to pay 10% CGT on £20m of lifetime capital gains (or £40m if you include their spouse / civil partners).

Deferred consideration

When a company is sold the consideration often includes deferred consideration. This falls into two camps:

- Unascertainable – in which case the objective is to agree with HMRC the market value of the deferred consideration "right" at the time of sale. The higher the better, because any consideration received above this amount is charged to CGT in the future at 20%, rather than 10% under Entrepreneurs' Relief in the tax year of the disposal. Any overpaid 10% CGT is refunded, so there is no risk of excessive tax being paid.
- Ascertainable, with warranty adjustment – the maximum proceeds are charged to CGT at 10% upfront under Entrepreneurs' Relief. If all of the proceeds are not received then any overpaid CGT is repaid. The buyer will, however, need to be happy with this approach.

Elect out of paper for paper

When a company is sold the consideration often includes shares or securities in the purchasing company. The buyer may be a far larger company and often the sellers end up owning far less than 5% of the share capital in the buyer, or don't have 5% of

the voting rights. Which means Entrepreneurs' Relief won't be available on the future disposal of the shares or securities in the purchasing company.

What the sellers can do is elect out of the paper for paper treatment on the sale of the shares and instead receive consideration shares in the buyer. This will have the benefit of crystallising the capital gain on that disposal so CGT can be paid at 10%. Only the future increase in value of the consideration shares will be subject to CGT at 20%.

Mix of cash / loan notes to limit upfront tax to ER £10m limit

1. On some large transactions where there is deferred consideration that is taxed upfront, it can beneficial to settle that deferred consideration in the form of loan notes. This is only relevant where you have different shareholder groups – some with large holdings and other smaller shareholders. That then enables:
2. Larger shareholders who will utilise their full £10m on the initial consideration to defer paying CGT on the deferred consideration until the loan notes are redeemed, when CGT will be paid at 20%; and
3. Smaller shareholders to elect out of the paper for paper treatment on the deferred consideration loan notes so that they can pay 10% CGT upfront on their deferred consideration, rather than 20% in the future.

What to remember

HMRC clearance

If there's one thing you take away it's that Entrepreneurs' Relief can always fail for one reason or another. The rules are widely drafted and subjective. Always submit a highly detailed – and complete – non-statutory clearance to HMRC. The same applies to Investors' Relief.

Self-assessment enquiry

HMRC seem to like enquiring into Entrepreneurs' Relief claims in individuals' self-assessment tax returns. So retain the appropriate information to prove all of the qualifying status tests are satisfied, or better still retain that HMRC clearance letter! Again, the same applies to Investors' Relief.

Qualified lawyer

It is alarmingly easy to fall foul of rules, for example where there are multiple share classes with different nominal values. Wherever possible, work with a lawyer who is familiar with Entrepreneurs' Relief (and Investors' Relief).

There can be no doubt how important Entrepreneurs' Relief and Investors' Relief are (even if they aren't the only reason people become entrepreneurs). Just keep a sharp eye out for all the complexities and traps lying in wait along the way.

David Marcussen's first article was on SEIS and EIS and his third will cover Enterprise Management Incentive share option plans.