Shedding new light

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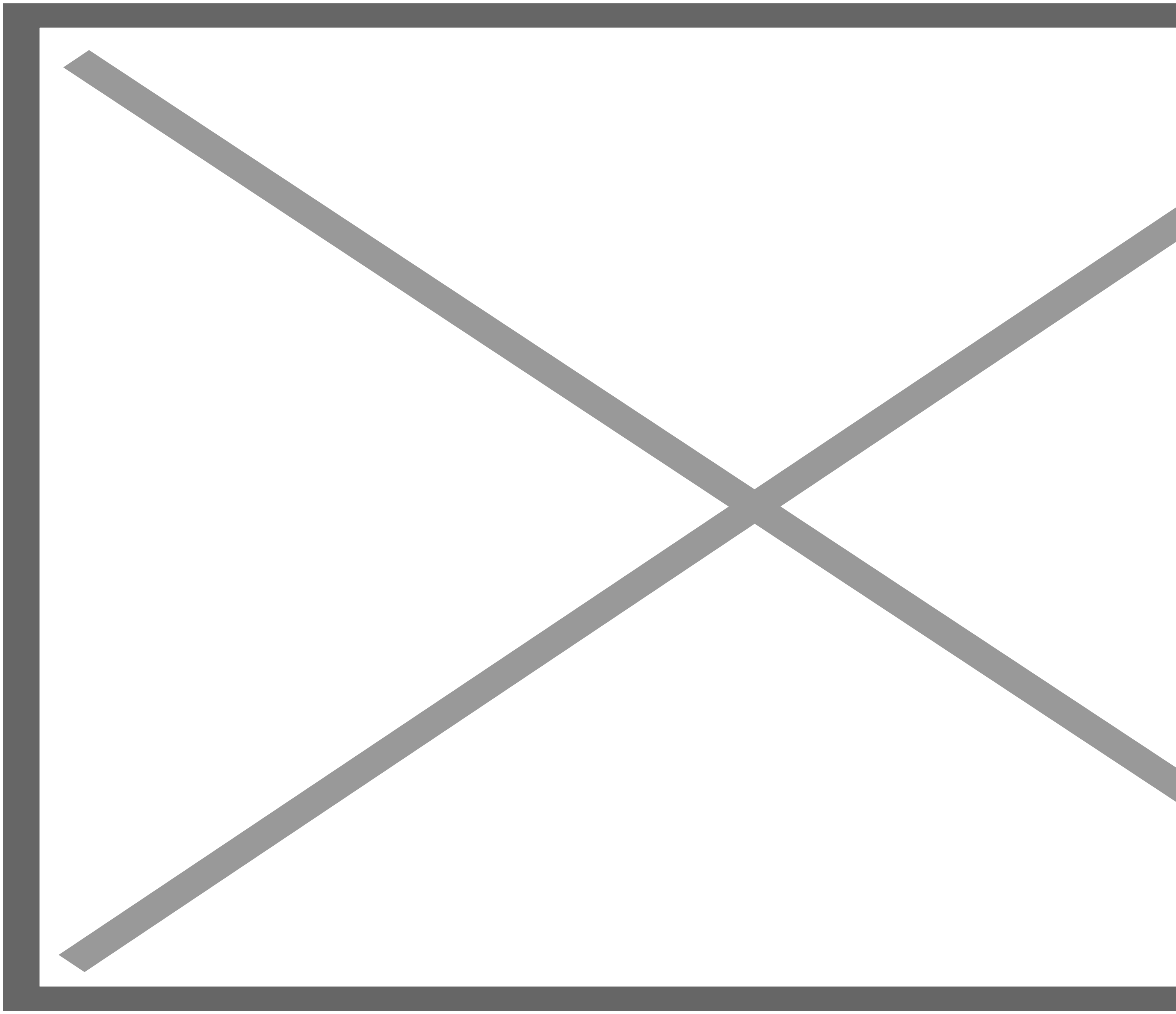

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Michelle Robinson considers some points of uncertainty in a round-up of recent cases tackling entrepreneurs' relief

Key Points

What is the issue?

The First-tier Tribunal (FTT) has recently heard three entrepreneurs' relief (ER) cases on different points of uncertainty.

What does it mean to me?

These cases contained decisions concerning cumulative compounding preference shares, the minimum period over which a life interest needs to be in place in order for ER to be available on a trust disposal, and the position of a company that undertakes activities in an attempt to revive a 'paused' trade.

What can I take away?

All three cases considered in this article provide more clarity on how the courts may interpret certain unclear elements of ER. However, FTT decisions are persuasive but do not legally bind the courts to reach the same conclusion in future cases.

After years of relatively stable legislation, Finance Act 2019 brought significant changes to the entrepreneurs' relief (ER) eligibility rules. These changes include doubling the minimum period over which the ER qualifying conditions must be met in order for relief to be available on material disposals (now two years instead of one). It also added an additional economic condition that must be met in order for ER to be available on company interests (referred to as the '5% test' in this article).

Despite these changes, much of the legislation remains as it was initially enacted by Finance Act 2008. Three recent First-tier Tribunal decisions have brought additional clarity to some longstanding areas of uncertainty.

It should be noted that as these are FTT decisions, the courts are not legally bound to follow the conclusions drawn when future cases are heard. The cases will, however, be persuasive in future FTT hearings, and legally binding precedent will be created if a higher court rules on the matters in dispute.

Of the cases considered in this article, the *Warshaw* and *Skinner* cases have been listed for appeal at the Upper Tribunal. Permission to appeal was granted in the *Potter* case considered in this article but, at the time of writing, no appeal has been listed at the Upper Tribunal.

All legislative references in this article are to TCGA 1992 unless otherwise stated.

Ordinary share capital: fixed compounding cumulative dividends

Warshaw v HMRC [2019] UKFTT 268 (TC) is the latest in a series of cases concerning the definition of ordinary share capital for ER purposes. *Warshaw* relates to a disposal that occurred before 6 April 2019. Mr Warshaw satisfied the 5% test if he owned at least 5% of ordinary share capital which conferred at least 5% of voting rights. Ordinary share capital for these purposes is defined in ITA 2007 s 989 as shares other than shares which carry a right to a dividend at a fixed rate but no other right to share in company profits. A different definition is relevant for the purposes of one limb of the new economic condition added to the 5% test by FA 2019, but was not considered in this case since it relates to a disposal that occurred before the new rule came into force.

Mr Warshaw held various classes of shares, including ‘preference shares’. These shares entitled the holder to a 10% fixed cumulative dividend, calculated based on the subscription price for the preference shares plus any unpaid preference dividends from earlier periods. The preference shares carried no other right to share in company profits.

Mr Warshaw’s shareholdings in the company were such that he only satisfied the 5% test if the preference shares were regarded as ordinary share capital.

Arguments and decision

HMRC’s position was that the shares carried a fixed rate of return as the 10% rate is fixed, albeit the amount to which the 10% rate applies may fluctuate depending on the amount of any unpaid preference dividends.

The case was, however, found in the taxpayer’s favour, on the basis that both the dividend rate and the amount on which the dividend is calculated must be fixed in order for shares to be preference shares for ER purposes.

Summary

Warshaw adds further clarity to the definition of ordinary share capital for ER purposes, which has long been an area of uncertainty. The Upper Tribunal has listed the case for appeal.

Interest in possession trusts: duration of life interest

ER is available on trust gains where, broadly, an individual who is eligible for ER on assets they own personally has an interest in possession (IIP) in a trust which holds interests in the same business or company. HMRC’s published view (in CG63985) differs from that of some industry practitioners, since HMRC consider that the IIP must have been in existence for at least two years (previously one year) pre-trust disposal in order for ER to be available.

This point was considered in *The Quentin Skinner 2005 Settlement L and others v HMRC* [2019] UKFTT 516. The judgment found for the taxpayer.

Key legislation

The key legislation considered was TCGA 1992 s 169J. Particular consideration was given to:

- s 169J(3), which requires a beneficiary to have an IIP otherwise than for a fixed term (a life interest would satisfy this point) in either the whole of the settled property, or in the part of the settled property on which ER is sought, and;
- s 169J(4), which is relevant on a disposal of shares or securities in a company, and states that ‘throughout a period of two years [previously one year] ending not earlier than three years before the date of the disposal:
    - the company is the qualifying beneficiary’s personal company and is either a trading company or the holding company of a trading group; and
    - the qualifying beneficiary is an officer or employee of the company’.

Arguments

A key element of HMRC's submission was that a plain reading of s 169J(4) is that the individual who is personally eligible for ER must be a qualifying beneficiary of the trust for the (then) one year ER eligibility period prior to disposal by the trustees.

By contrast, the taxpayers' case was that a plain reading of s 169J(4) imposes no such requirement. Instead, the structure of the ER legislation is to grant ER where an individual has an 'entrepreneurial connection' with a company. This entrepreneurial connection is determined using the 5% test. Section 169J(4) states that this entrepreneurial connection has to be in place throughout a one year period (under the pre-6 April 2019 time limits) ending no earlier than three years before the disposal by the trustees, but s 169J(4) does not make any reference to the length of time the IIP must be in place pre-disposal by the trustees.

Decision

It was held that, as there are no authorities for the words used in s 169J(4), the words used take their natural meaning which does not impute a minimum period for the interest in possession. This interpretation is consistent with the way that ER operates on assets held personally, since an individual is able to claim ER on business assets held for less than a day and sold as part of the disposal of a business if he or she otherwise satisfies the entrepreneurial connection requirement.

The decision also stated that this interpretation of the legislation is consistent with the clear intention of Parliament, as expressed in the Explanatory Notes to Finance Act 2008. This intention is, in essence, to impose an entrepreneurial connection requirement in order for ER to be available, albeit with somewhat different application in the context of trusts (the 'three year window').

Summary

The *Skinner* case provides welcome clarity with regards to the ER position of trusts, with the finding that there is no minimum period over which an interest in possession trust business assets must be in existence in order for ER to be available on trust gains, provided the ER conditions are met by the individual personally. The case has been appealed to the Upper Tribunal.

Date of trade cessation

The FTT found in favour of the taxpayer in *J Potter and N Potter v HMRC* [2019] UKFTT 554. This case focused on when a company ceased trading and, provided this was within three years of liquidation such that ER was relevant, whether or not the company had substantial non-trading activities.

While the facts in the case are unusual, the case is interesting because the company had not received trading income for six years before liquidation and its income and assets in this six year period were predominantly or entirely investment in nature.

The Potters were shareholder directors of Gatebright Ltd. Gatebright traded in the London Metal Exchange and brokered credit deals to provide clients with finance in order to engage in high-value trading at the Exchange. Gatebright was a successful business and had reserves of £1m at the time of the 2008/09 financial crisis, at which point the volume of trades decreased dramatically. Gatebright issued its last invoice in March 2009.

The company was liquidated on 11 November 2015. It was accepted that ER was available provided the company was trading in the year up to 12 November 2012 (three years before liquidation) and not carrying on substantial non-trading activities.

Arguments

HMRC's position was that the company ceased trading when it issued its last invoice in March 2009. HMRC's contention was that, even if the cessation was intended to be temporary, the fact that it became permanent means that March 2009 is the relevant date.

HMRC referred to the retirement relief case of *Marriott v Lane (HM Inspector of Taxes)* [1996] BTC 297, but the court distinguished this case from the *Potter* case, since there was no intention in the *Potter* case to cease trading, temporarily or otherwise, until 2014 at the earliest.

Mr Potter argued that the company had been actively engaged in activities with a view to carrying on a trade and resuming normal business throughout the period from March 2009 to June 2014. However, the financial crisis, his ill health and other challenging personal circumstances had resulted in a series of setbacks that had made it impossible for the company to regain its former health.

Decision

A company qualifies as a trading company if, among other conditions, it is either carrying on a trade or preparing to carry on a trade (s 165A). It was found that Mr Potter's activities were such that, until at least November 2012, the company was at the very least preparing to carry on a trade (i.e. resuming the old trade, which is described as having 'paused'), and so this element of the ER conditions was met.

The next point considered was whether the company was carrying on non-trading activities to a 'substantial' extent. 'Substantial' is not defined in the legislation, but is taken to mean more than 20% of a company's activities, determined using a balance of indicators, as summarised in HMRC's guidance in their CGT Manual at CG53116.

The judge noted that the company's activities must be determined by reference to activities undertaken 'in the round'.

In Gatebright's case, there were activities pointing in both directions. Between 2009 and 2015, the company's income and assets were predominantly or entirely non-trading. Approximately £800,000 of the company's aforementioned £1m reserves were invested in six year investment bonds that matured in November 2015. The remaining c. £200,000 was initially held in cash as working capital but was distributed between 2009 and 2015. Aside from 'trivial' amounts of bank interest received in 2010 and 2011, the company's only income in this period was investment income from the bonds. On the other hand, the directors' time and the company's expenses related to attempting to revive the trade. It was noted that no activity could be undertaken in relation to the investment bonds once they were on long-term deposit.

It was decided that, in the round, the company's activities were more likely than not trading in nature, as the activity undertaken was 'directed at reviving the company's trade and putting it in a position to take advantage of the gradual improvement in global financial conditions'. Furthermore, it was found that the activity undertaken did not include non-trading activities to a substantial extent.

Evidence

The emphasis on activity and weight given to the time spent and expenses incurred is interesting. In practice, determining how employees and directors have spent their time may be one of the hardest factors to determine as limited records of time spent may be maintained.

In the *Potter* case, no documentary evidence was available with regards to Mr Potter's attempts to revive the company's trade. However, the court found Mr Potter to be a trustworthy and credible witness and the record of expenses in the financial accounts and facts set out in HMRC correspondence were consistent with his witness account. Furthermore, the length of time between the last sale in 2009 and HMRC enquiry following the 2015 liquidation meant that it 'was not surprising' that the company's informal records were no longer available.

Summary

Whilst limited evidence was available in this case, those advising clients may wish to recommend that clients maintain records to evidence time spent and other documentation to support the trading position, given that the burden of proof is on the taxpayer. It should also be noted that any decision in this area will be highly fact specific, having regard to all the facts and evidence available.

Conclusion

These decisions have added clarity to a range of unclear points. However, as the decisions are FTT decisions, they are persuasive but do not bind other tribunals in future hearings. The outcome of the Upper Tribunal hearing of the *Warshaw* and *Skinner* cases and any appeal heard on the *Potter* case will be important developments in this area.