Lifting off

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Jacqueline Kimber considers the options for businesses to take advantage of tax reliefs available

Key Points

What is the issue?

Investors’ Relief introduces a valuable capital gains tax relief for passive investors not fitting within the confines of SEIS/EIS.

What does it mean to me?

The relief applies only to new issues of shares, so it is worth looking at client's fundraising requirements to see if any future share issues could attract the relief.

What can I take away?

Although mirroring Entrepreneurs' Relief in many respects, there are additional complexities with Investors' Relief which need to be considered.

Encouraging investment in unquoted trading companies has been a theme in many recent and not so recent Budgets. On the one hand, there is the vastly complex but comparatively generous Enterprise Investment Scheme, and more recently the Seed Enterprise Investment Scheme, both of which can be attractive for those willing to risk their capital with minimal, if any, day to day involvement in the business. At the other end of the scale there is Entrepreneurs' Relief which, until 6 April 2016, was the principal capital gains tax relief available to holders of shares in unquoted trading companies (reducing the rate of tax to 10%).

The introduction of Investors' Relief from April 2016 is arguably a middle ground, and one which will be welcomed. Investors' Relief relies heavily on many of the principles established within the Entrepreneurs' Relief and Enterprise Investment Scheme legislation.

Entrepreneurs' Relief

The basic concept behind entrepreneurs' relief as it applies to a disposal of shares or securities is well known: for there to be a 'material disposal of business assets' (TCGA 1992 s 169I(6)) the individual shareholder must have owned the shares or securities throughout the period of one year ending with the date of disposal, and during the same period the company must be the individual's 'personal company', and a trading company or the holding company of a trading group. A company is an individual's personal company if he/she possesses at least 5% of the ordinary share capital and, *by reason of that holding*, is able to exercise at least 5% of the voting rights. The words in italics are important, as they prevent relief being claimed by the individual where shares are held, for example, through a family trust. The individual must also be an employee or officer of the company, or of one or more group companies, through the 12 month period ending with the date of disposal. There is no requirement for the employment to be either for a set number of hours or paid.

The relief is extended to accommodate the situation where a company has ceased trading, without continuing to be a member of a trading group, or ceases to be a member of a trading group without continuing to be a trading company. In that case, provided the employment and personal company conditions have been met throughout the 12 months ending with the time the company (or group) ceases to meet the 'trading' requirement, Entrepreneurs' Relief will be due on a disposal of shares or securities taking place within three years of the date of cessation.

For most owner-managers, these conditions are unlikely to be problematic and, provided care is taken over practical stumbling blocks, such as ensuring directors do not resign from office *before* a share sale takes place, claiming Entrepreneurs' Relief should be a relatively straightforward matter. It should be noted that the relief applies not only to a disposal of ordinary shares, but *any* shares or securities, provided that the conditions above are met. So, for example, where an employee shareholder holds both ordinary shares and preference shares, a disposal of the preference shares will attract Entrepreneurs' Relief provided his/her ordinary shareholding meets the 5% and other tests. A further anomaly is that the relief will apply to a disposal of shares even if part, or indeed the majority, of a shareholding has been acquired in the last 12 months. This means that if a 5% shareholding has been held for a number of years, but in the 12 months preceding a disposal an additional (say) 50% is acquired, the sale of the entire holding will attract Entrepreneurs' Relief (subject of course to the other conditions in s 169I being met and the £10m lifetime limit not being breached).

Owner-shareholders are, therefore, relatively well accommodated. The bugbears with Entrepreneurs' Relief have always been the requirement to hold an office or employment and the 5% ownership threshold, both of which may be difficult for someone who has provided valuable financial support to the business, as in the typical 'business angel' situation. Some such individuals will be able to invest within the confines of the EIS and SEIS rules, and their willingness to take on risk is rewarded with an exemption from capital gains tax on the disposal of their shares provided the (broadly) three year qualifying period has passed. However, the EIS and SEIS both have stringent conditions attaching to the type of individual who can qualify, the nature of shares which can be issued, and how and when funds are used, as well as to the size and age of the company and the type of activity in which it may engage in order to qualify for relief. For many businesses, particularly those which have been in existence for longer than the seven or ten years permitted under the EIS rules, attracting investment from new shareholders has become increasingly difficult. The introduction of Investors’ Relief is intended to plug this gap.

Investors’ Relief

In concept, Investors’ Relief is reasonably straightforward: investors in ordinary shares are given a separate £10 million lifetime limit of gains charged at 10% if they invest in ordinary shares in unquoted trading companies. In practice, the relief is more complex than Entrepreneurs’ Relief (upon which it is based), owing to the need to consider ‘connected’ persons (using the TCGA 1992 s 286 definition, where a ‘relative’ has a wider definition than that applying for EIS in ITA 2007 s 253) when considering whether the various conditions are met, and also the lifting of the ‘value received’ provisions almost directly from the EIS rules, which are not known for their clarity and ease of application. As for EIS, we also have to consider ‘associates’, as well as connected persons, for example if considering whether the investor has received ‘value’ under TCGA 1992 Sch 7ZB paras 2 and 3. The principal requirement for Investors’ Relief to apply is that an individual must subscribe in cash for fully paid up ordinary shares on or after 17 March 2016 and retain those shares for at least three years from 6 April 2016. The limitations compared to Entrepreneurs’ Relief are immediately obvious: Investors’ Relief only applies to shares acquired by subscription (or through certain inter-spouse transfers), and only to disposals of ordinary shares held for a much longer minimum period, in line with the relief’s aim of encouraging longer term investment. On the other hand, there is no 5% shareholding requirement and, unlike EIS and SEIS, there is also no maximum investment threshold.

The shares must be issued by an unquoted trading company or holding company of a trading group, with the definitions (as for Entrepreneurs’ Relief) borrowed from the holdover relief provisions of TCGA 1992 s 165, but with the added provision that a company will be treated as continuing to trade after it has entered administration, receivership or liquidation, provided this is for genuine commercial reasons and not for the avoidance of tax. Neither the investor nor a person connected with him/her can be an employee or director of the share issuing company or connected company during the shareholding period. However, thanks to a late relaxation in the rules before Finance Act 2016 received Royal Assent, an individual who has subscribed for shares and subsequently takes up the role of an unpaid director with either the issuing company or a connected company is not disqualified for Investors’ Relief purposes, provided the individual (or anyone connected with him/her) is not connected with the issuing company prior to the issue of the shares, or involved in carrying on the trade of that company or a connected company. It is also permitted for a shareholder to take up paid employment, other than a directorship, with the issuing company provided more than 180 days have passed since the issue of the shares, and there was no realistic prospect of the person becoming an employee at the time the shares were issued (TCGA 1992 s 169VW).

Conclusion

As has already been mentioned, Investors’ Relief lifts large parts of the EIS rules and imports them into the Investors’ Relief provisions, notably in relation to the concept of ‘value received’. These rules seem prohibitively restrictive even in the context of EIS and SEIS, where the tax breaks on offer are much more generous, so their appearance in the Investors’ Relief rules is somewhat disappointing. Although some form of prohibition on extracting value in artificial ways is understandable, the ‘copy and paste’ approach adopted seems like lazy drafting in the context of Investors’ Relief.

It is early days for the new relief, and it won’t be until 2019 that we see the first claims for Investors’ Relief. There is arguably still too large a gap between the availability of Investors’ Relief and Entrepreneurs’ Relief: it doesn’t seem quite fair that an employee shareholder who perhaps has suffered dilution to below 5% through the issue of new shares (perhaps to Investors’ Relief shareholders!) will end up paying capital gains tax at twice the rate of someone who has not invested both their working efforts and money in the business. But who said tax was fair?

Further information

For more on the use of Investor’s Relief and reorganisations, read Caroline McCabe’s article, ‘Welcome incentive’ in the July 2016 issue of *Tax Adviser*.