

Entrepreneur's Relief

Overview

Capital gains tax Entrepreneur's relief (ER) reduces the rate of capital gains tax (CGT) payable on disposals of "business assets", as defined. It can be claimed on a lifetime total of £10million of capital gains, and reduces the rate of CGT from 28% to 10% and thus is considered an extremely favourable relief.

This has not always been the case since the inception of the relief in 2008, however, the rates of CGT have since increased and the ER lifetime limit has increased significantly. Both of these factors have considerably increased the tax savings associated with the relief.

The relief is not applied automatically and needs to be claimed on or before the anniversary of the first 31 January following the end of the tax year in which the relevant gain was realised.

There were some changes announced in the Budget 2018 which may impact on some disposals already made in 2018/19 and will need to be considered going forward.

The relief can be claimed by individuals and trustees.

When is the relief available?

ER is available on a 'material disposal' of business assets or disposals associated with such disposals.

For a disposal to be a 'material disposal' of business assets it must represent one of the following:

- I. The whole or part of a trading business;
- II. Assets used in a trading business at the time it ceased trading; or
- III. Shares or securities in the claimant's "personal company" which is a trading company or the holding company of a trading group.

"Whole or part of a business"

In the case of a sole trader, or a partnership, the disposal must be of the whole business or "part of a business".

A disposal of the whole of a trading business generally does not cause issues, however, it is the concept of the "part of a business" that does. The availability of the relief in this regard is subject to much of the case law that was decided on this point in the context of the availability of the former 'retirement relief' upon which ER is based.

Broadly, ER only applies to a disposal of a clearly identifiable part of the whole business. This can cause issues with interpretation as to whether a part of a business has been sold, or mere assets that have been used in the business where no cessation has occurred (the former means ER is available, and the latter means no ER is available). The answer to this question generally comes down to the facts of each case.

The business must have been owned by the claimant for at least the 1 year period ending on the date of disposal, for disposals up to 5 April 2019; and for disposals after this date the ownership period is extended to 2 years ending on the date of disposal.

Asset used in the trading business at the time of cessation

In order for ER to be available on such assets, the disposal must be made within 3 years of the date of the cessation of the trading business.

The business must have been owned by the claimant for at least the 1 year period ending on the date the trade ceased to be carried on, for disposals up to 5 April 2019; and for disposals after this date the ownership period is extended to 2 years ending on the date the trade ceased to be carried on. However, if the company ceased before 29 October 2018 there is a transitional period and the existing 1 year qualifying period will continue to apply for all disposals of assets within 3 years.

Disposals of shares

In order to qualify for ER, the shares disposed of must be shares in a trading company, or the holding company of a trading group of companies. A company, or a group of companies, is “trading” provided any non-trading activities carried on by it (or the group as a whole) are not “substantial”. “Substantial” means 20%, but the test is applied to non-trading income (such as rent), as well as to asset values, and even the amount of time spent by management and staff on non-trading activities.

It is possible to ask HMRC for an opinion on whether a particular company or group would fail the “substantial” test, and this should be considered in doubtful cases, but take advice from a firm of experienced tax advisers first.

Historically there has been two other conditions the shareholder must meet, these being:

- They must be an “officer or employee” of the company; and
- Before the disposal, hold enough of the company’s ordinary share capital to give him not less than 5% of the total votes held by the company’s shareholders.

All these conditions must be met for at least twelve months, ending on the date of the disposal of the shares or, if the company has ceased trading, ending on the date the trade ceased. In this latter case, the shareholder has 3 years from the date of cessation to dispose of the shares in order for any resulting gain to qualify for ER.

In the Budget 2018 it was announced that there will be an additional two conditions to meet, as follows:

- The individual must be entitled to 5% of the company’s distributable profits; and
- There must be 5% of the assets available for distribution on a winding up for an equity holder.

An alternative test was proposed in the Finance Bill which gives relief if the individual is entitled to at least 5% of the sale proceeds in the event of a disposal of the whole of the ordinary share capital of the company.

All of the previous conditions and the two new conditions, for disposals from 29 October 2018, or the alternative test, for disposals from 21 December 2018, must now be met for at least 2 years, ending on the date of the disposal of the shares or, if the company has ceased trading, ending on the date the trade ceased. In this latter case, the shareholder has 3 years from the date of cessation to dispose of

Finally, ER can only apply to any gain realised on the disposal of shares by employee shareholders that are subject to capital gains tax. Anti-avoidance rules exist to treat all or part of such gains as deemed income (and thus subject to income tax) where these rules apply. In such circumstances, ER would not be available as it is purely a capital gains tax relief. Consequently, it is prudent to assess whether such gains will be entirely subject to capital gains tax when considering such share sales.

Associated disposals

If shares or a partnership interest are disposed of, ER can apply not only to that disposal, but also to the “associated disposal” of an asset. This typically applies to business premises owned by the shareholder or partner, but used by the business.

If, however, the business has paid rent to the shareholder/partner for such premises, ER is restricted in proportion to the amount of rent paid – and entirely denied if the rent is at full market value. This only applies, however, to rent paid after 5 April 2008, when this change in the rules was made.

The asset must have been used in the business for at least either the 1 year period ending on the date of the ‘material disposal’ or the cessation of the trade of the business.

Planning

Given that ER is an extremely beneficial relief, when considering any disposal of a business asset it is prudent to consider its availability well in advance, particularly given the 2 year period conditions and the detail of the transitional period. ER should be a significant consideration in any exit strategy.

We have extensive experience of advising on the availability of ER, and advising on planning to consolidate and/or enhance the position.

If you would like to find out more about the Entrepreneurs’ Relief and how we at RRL can assist, please contact our Tax Partner, Steve Maggs, on 01872 276116 or steve.maggs@rrlcornwall.co.uk

Updated 7 March 2019

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