

ENTREPRENEURS' RELIEF

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1. Entrepreneurs' Relief (**ER**) has been with us since 6 April 2008. When it was introduced in FA 2008 it offered an effective 10% rate of tax on £1 million of gains in a person's lifetime, rather than the 18% rate which would apply if the relief was not available. This was a maximum lifetime tax saving of £80,000.
2. By contrast, FA 2011 having extended the relief to £10 million of gains and which would otherwise be taxable at 28, the maximum lifetime tax saving offered by ER is now £1.8 million. This has made the relief more interesting, and has meant that it is more likely to be worthwhile taking steps to secure it.

THE RELIEF IN OUTLINE

3. ER applies in different ways to disposals by individuals and disposals by trustees. In addition it covers disposals of the whole or part of sole trader business or of a partnership as well as the disposal of shares in a company. The business in question will have to qualify as a trade if carried on by a company, but otherwise need only be a business.
4. To qualify for ER there must be either (i) a material disposal of business assets (section 169I TCGA 1992) (ii) a material disposal of trust business assets (section 169J TCGA 1992) or (iii) a disposal associated with a relevant material disposal..
5. The relief is also extended to certain assets which were used in a business which has ceased.
6. The relief operates by reducing the charge on a gain to 10% but is only available as

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to £10 million of qualifying gains in a person's lifetime.

MATERIAL DISPOSAL OF BUSINESS ASSETS: SHARES IN A TRADING COMPANY

7. A disposal of shares or securities in a company by an individual will qualify for relief if for the period of 1 year prior to the disposal:
- 7.1 it is the individual's personal company;
 - 7.2 it is either:
 - 7.2.1 a trading company; or
 - 7.2.2 the holding company of a trading group;
(“the trading condition”)
 - 7.3 the individual is either:
 - 7.3.1 an officer or employee of the company; or
 - 7.3.2 an officer or employee of one or more companies which are members of the trading group.
(“the officer or employee condition”).

The trading condition

8. A **trade** is defined in section 165A(14) TCGA 1992:

“trade” means (subject to section 241(3)) anything which-

- (a) is a trade, profession or vocation, within the meaning of the Income Tax Acts, and*
- (b) is conducted on a commercial basis and with a view to the realisation of profits.*

9. A **trading company** is defined in section 165A(3) TCGA 1992:

“Trading company” means a company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities.

10. A **trading group** is defined in section 165A(8) TCGA 1992:

“(8) “Trading group” means a group of companies-

(a) one or more of whose members carry on trading activities, and

(b) the activities of whose members, taken together, do not include to a substantial extent activities other than trading activities”.

11. A **group of companies** is defined in section 165A(14) TCGA 1992:

“group of companies” means a company which has one or more 51% subsidiaries together with those subsidiaries

12. HMRC generally take a substantial extent to mean more than 20% (CGT Manual 64090) by reference to factors such as income from non-trading activities; the asset base of the company; expenses incurred, or time spent, by officers and employees of the company in undertaking its activities; and the company's history. Each of the factors should be balanced and a view taken in the round: see *Farmer and anor v IRC* [1999] STC (SCD) 321, and individual factors concerning the business may of particular relevance

13. HMRC accept that an activity is carried on in the course of, or for the purposes of, a trade if it is carried on in the process of conducting or preparing to carry on the trade (CGT Manual 64060).

14. As a result the purpose for which assets are acquired can be relevant to whether they form part of trading or investment activities. For example, land can be acquired (i) for development (trading) (ii) with a view to becoming part of the premises of the trade (trading) or (iii) to secure a future rental income (investment). Similarly, short terms investments may be closely linked with future trading activities e.g. where they are to be used for trade purposes in the future.

15. Difficulties can arise where assets are acquired with a trading purpose but due to extraneous matters – for example a change in trading conditions - that purpose is no longer relevant.

Company ceasing to be a trading company

16. Relief will continue to be available if the conditions set out in paragraph 7 were satisfied for a continuous period of one year ending on a date at some point in the three years prior to disposal and on that date the company:

“(a) ceases to be a trading company without continuing to be or becoming a member of a trading group, or

(b) ceases to be a member of a trading group without continuing to be or becoming a trading company” (section 169I(7) TCGA 1992).

17. Although this clearly covers the situation where a business ceases to be carried on, it would also seem to cover the situation where a business continues to be carried on but the company ceases to be trading company because it carries on investment activities to more than a substantial extent.
18. As a result, the relief will be available for investment companies provided that the company was a trading company for a continuous period of one year ending at a date within the three years prior to disposal. This extension of the relief may in some circumstances ease some of the difficulties which can arise around increases in investment activity.

Personal company

19. **Personal company** is defined in section 169S(3) TCGA 1992 in the following terms:

(3) For the purposes of this Chapter “personal company”, in relation to an individual, means a company-

(a) at least 5% of the ordinary share capital of which is held by the individual, and

(b) at least 5% of the voting rights in which are exercisable by the individual by virtue of that holding.

20. **Ordinary share capital** is given the same meaning as in section 989 ITA 2007 which states:

“ordinary share capital”, in relation to a company, means 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,

21. Points to note:

21.1 Ordinary share capital does not include shares with a fixed dividend and no other right to share in the company's profits:

21.1.1 look to the articles of the company in determining whether there is a dividend at a fixed rate: *Tilcon Ltd v Holland* [1981] STC 365;

21.1.2 shares where the dividend rate is fixed by reference to a variable index may not qualify since the rate is variable, not fixed;

- 21.1.3 a right to a premium on redemption is a right to share in the company's profits, so shares carrying such a right will be ordinary share capital.
- 21.2 The individual must have 5% of the voting rights by virtue of his holding of ordinary share capital:
 - 21.2.1 Voting rights which are exercisable indirectly through control of a shareholder company will not count: *Boparan v HMRC* [2007] STC (SCD) 297
 - 21.2.2 voting rights held exercisable under a shareholders agreement are unlikely to be sufficient (see the unresolved argument in *Gray's Timber Products Ltd v HMRC* [2010] STC 782 as to the relevance of an external agreement to share rights);
 - 21.2.3 voting rights conferred by fixed rate shares will not count towards the 5% necessary to qualify for ER but will not be disregarded in determining the percentage;
 - 21.2.4 ordinary share capital should still qualify for ER even if it doesn't carry voting rights, provided that enough ordinary share capital does carry voting rights.
- 21.3 If altering share capital to come within the relief, care should be taken:
 - 21.3.1 the shares are almost certainly going to be employment related securities so the provisions of Part 7 ITEPA 2003 need to be borne in mind;
 - 21.3.2 there could be a value shift giving rise to a deemed disposal (section 29 TCGA 1992). Query whether that applies on a reorganisation (*Young v Phillips* [1984] STC 520).

The officer or employee condition

22. What is required to qualify as an officer or employee? Guidance on the issue of whether a person is an officer or employee for purposes of entrepreneurs' relief is provided by the HMRC Capital Gains Tax manual states in this respect that:

Generally whether a person is an officer or employee of a company or not is dependent upon whether that person has an employment or holds an 'office' within the meaning of Section 4 ITEPA 2003 and Section 5(3) ITEPA 2003 - for guidance on these areas see the Employment Status Manual.

There are no specific requirements regarding either working hours or the level of remuneration. The condition is simply that the individual should be an officer or employee.

23. The reference to there being no specific requirements regarding working hours or level of remuneration is a contrast with previous similar provisions which required the individual to be a “full-time working officer or employee” (see for example retirement relief and the former section 163(5)(b) TCGA 1992). This is in line with the stated aim of extending the relief beyond full time employees to include certain ‘business angels’ and other business investors (see the Statement by the Chancellor of the Exchequer on CGT reform - entrepreneurs’ relief of 24 January 2008).

Officers

24. The easiest way to secure that a person comes within the requirement that he or she be an officer or employee is to appoint him or her a director of the company since this can be objectively shown. Care should be taken, however, to ensure that the person is in fact acting as a director and that the office is not held in name only. It is likely on a purposive construction that it will be necessary to show a real connection with the business.
25. It is noted that the relief will be available if the individual is an officer of one or more companies which are members of the same trading group as the company whose shares are disposed of. It may be easier from a commercial point of view to appoint a person as a director of a subsidiary in the same trading group. It would, however, be a risk to rely on directorship of a dormant subsidiary where the director had no duties.

Employees

26. Showing employment may be less of a commercial obstacle: an employee need not be involved at the higher echelons of the business in the way that a director must be, nevertheless, if employment is relief upon must be a real one. In that respect, an employment of at least 10 hours per week (which is the requirement of the non-active partner provisions) will almost certainly qualify. That is not a fixed requirement, however, and clearly a lesser number of hours which might not be on a regular basis can be adopted if it can be shown that an employment relationship does not exist.
27. There is a considerable amount of case law concerning when a person is an employee. The issue was again considered by the Supreme Court in its recent decision *Autoclenz Ltd v Belcher* [2011] UKSC 41. There it was noted that the essential question in each case will be what were the terms of the agreement.

28. The classic description of a contract of employment is provided by MacKenna J in *Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance* [1968] 2 QB 497 where he stated:

'A contract of service exists if these three conditions are fulfilled.

(i) The servant agrees that, in consideration of a wage or other remuneration, he will provide his own work and skill in the performance of some service for his master. (ii) He agrees, expressly or impliedly, that in the performance of that service he will be subject to the other's control in a sufficient degree to make that other master. (iii) The other provisions of the contract are consistent with its being a contract of service.

As to (i). There must be a wage or other remuneration. Otherwise there will be no consideration, and without consideration no contract of any kind. The servant must be obliged to provide his own work and skill. Freedom to do a job by one's own hands or by another's is inconsistent with a contract of service....'

29. In addition "there must . . . be an irreducible minimum of obligation on each side to create a contract of service" per Stephenson LJ in *Nethermere (St Neots) Ltd v Gardiner* [1984] IRLR 240.
30. As such, if employment status may be questionable, it should be evidenced by a written contract requiring the individual to use his or her work and skill in the performance of a service, subject to the control of the company and in return for a wage. There must be no right of substitution and there must be real obligations created by the agreement.
31. To the extent that flexibility is desirable, the employing Company as employer should retain a sufficient degree of control that the employment relationship is not jeopardised. Performance of duties should not be left to the whim of the employee.
32. These issues will of course be less problematic the greater the involvement that the employee has with the company – there will be situations where the employment relationship is obvious.
33. It is also to be noted that the Supreme Court in *Autoclenz* stressed that the "question in every case is ... what was the true agreement between the parties" (per Lord Clarke at paragraph 29) and that the court can go beyond (and indeed against) the terms of the written agreement in determining what that true agreement is:

"... the relative bargaining power of the parties must be taken into account in deciding whether the terms of any written agreement in truth represent what was agreed and the true agreement will often have to be gleaned from all the circumstances of the case, of which the written agreement is only a part".

34. Normally HMRC will be arguing that a person is an employee, so it may be unexpected for them to argue to the contrary, although that was the situation in *Bell v HMRC* TC01234. The fact that the FTT was prepared to hold that the appellant was self-employed is a warning of the different approach which is likely to apply:

“33. In reality it is necessary for the main contractor to have overall control of the work being done, as he must build to the specification required in his own contract. However, provided the work is done to the standard required and in the position required, he exercises no other control over the manner in which it is done. The Tribunal found that the mere fact that workers were told what to do by a site foreman does not amount to control by MECL

34. The fact that the times of work were specified by MECL does not, in the finding or the Tribunal amount to control. For health and safety reasons, it is sensible to have set site times and in the finding of the Tribunal, this does not demonstrate the sort of control necessary to demonstrate that the appellant was an employee rather than performing a contract for services.”.

35. This does not seem to be entirely consistent with the approach in *Autoclenz* although it is perhaps unsurprising in the context of an FTT decision.

MATERIAL DISPOSAL OF BUSINESS ASSETS: SOLE TRADER

36. A disposal of *the whole or part of a business* qualifies for relief if the business was owned by the individual for the period of one year ending on the date of the disposal.
37. There is no restriction on a **business** requiring it to be a trade. This would suggest a wider range of activities might qualify for relief e.g. property investment (*American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue* [1978] STC 561) – although given that investments are excluded from being relevant business assets this raises issues of whether an investment business is the same as investments.
38. A distinction is drawn between assets of the business and part of the business:
- 38.1 *McGregor v Adcock* 51 TC 692 – sale of farmland was a sale of assets not a sale of part of the farming business;
- 38.2 *Atkinson v Dancer* 61 TC 598 – sale of farmland as part of winding down of business – it is a question of fact in each case whether there has been such an interference with the whole complex of activities and assets as could be said to amount to a disposal of the business or a part of the business;

- 38.3 *Pepper v Daffurn* 66 TC 68 – change in nature of business before disposal meant that yard not necessary to carry on business in same manner, so not a sale of part of the business;
 - 38.4 *Jarmin v Rawlings* 67 TC 130 – actions after the disposal including subsequent disposals taken into account where there was a sufficient connection, so there could have been a disposal of a dairy business;
 - 38.5 *Wase v Bourke* 68 TC 109 – sale of a milk quota after cessation of dairy business only a disposal of an asset of the business;
 - 38.6 *Barrett v Powell* 70 TC 432 – surrender of a tenancy for a licence a disposal of an asset since business carried on;
 - 38.7 *Purves v Harrison* 73 TC 390 – sale of premises 9 months before the sale of the rest of the business and to a different not sufficiently connected to be a sale of part of the business.
39. Query the difference between a business and a part of a business in the context of an investment business?
40. Some of the issues which arose in respect of retirement relief are removed by provision that a sale of assets will qualify for relief where:
- 40.1 the business has ceased;
 - 40.2 the assets were used for the purposes of the business at the time the business ceased to be carried on;
 - 40.3 the business was owned by the individual for one year at the time at which it ceased to be carried on (*note that this does not require the asset to be owned for a period of one year when the business ceased*);
 - 40.4 the business ceased within three years of the date of the disposal.

Relevant business assets

41. The relief is restricted to assets including goodwill used for the purposes of the business carried on by the individual but excluding shares and securities and other assets which are held as investments (section 169L TCGA 1992).

MATERIAL DISPOSAL OF BUSINESS ASSETS: PARTNERSHIP

42. The relief is extended to partnerships in three important respects:

- 42.1 a disposal of assets used for the purposes of a business carried on by the individual on entering into a partnership which is to carry on the business is deemed to be a disposal of part of the business;
- 42.2 a disposal of the whole or part of the individual's interest in the assets of a partnership deemed to be a disposal of the whole or part of the business carried on by the partnership, and
- 42.3 a business carried on by a partnership deemed to be owned by each individual who is at that time a member of the partnership

Relevant business assets

- 43. The relief is restricted to assets including goodwill used for the purposes of the business carried on by the partnership but excluding shares and securities and other assets which are held as investments (section 169L TCGA 1992).

TRUST ASSETS

- 44. There is no relief where trustees dispose of the whole or part of a business. Relief for trustees is restricted to settled property which :
 - 44.1 shares or securities of a company; or
 - 44.2 assets used in a business;
 - 44.3 assets previously used for the purposes of a business.

Query whether a disposal of a business or of part of a business would be regarded as a disposal of all of the assets used in the business?

- 45. For the relief to apply the settled property must be
 - 45.1 held on interest in possession trusts
 - 45.2 which are not for a fixed term
 - 45.3 for the benefit of a beneficiary (“the Beneficiary”)
 - 45.4 and for a period of one year ending on a date in the three years prior to disposal:
 - 45.4.1 the settled property is shares in a company which is (i) the

Beneficiary's personal company (ii) which meets the trading condition and (iii) the Beneficiary meets the officer or employee condition;

45.4.2 the settled property is assets used for the purposes of a business carried on by the Beneficiary (alone or in partnership) which has ceased;

45.4.3 the settled property is assets used for the purposes of a business carried on by a partnership which the Beneficiary has left.

46. Points to note:

46.1 the Beneficiary need have no interest in the capital of the trust fund;

46.2 Part 7A ITEPA 2003 may need to be borne in mind when appointing interests for employees;

46.3 for shares to qualify, the company the requirements relating to the beneficiary must be satisfied independently from the trustees' ownership;

46.4 this offers an opportunity for A to obtain the benefit of B's ER lifetime allowance;

46.5 short term small value partnerships with a Beneficiary may allow relief to be obtained where an asset is being sold from an ongoing business;

46.6 where settled property is held on non qualifying trusts, the relief is reduced proportionately (section 1690 TCGA 1992).

Relevant business assets

47. Where the disposal is of assets, the relief is restricted to those assets including goodwill used for the purposes of the business carried on by the Beneficiary or the partnership of which he was a member, but excluding shares and securities and other assets which are held as investments (section 169L TCGA 1992).

DISPOSAL ASSOCIATED WITH A RELEVANT BUSINESS DISPOSAL

48. ER is also available where an individual disposes of an asset and:

48.1 an individual makes a disposal qualifying for ER of (i) shares or securities in a company or (ii) an interest in a partnership (the material disposal);

- 48.2 the material disposal is part of the individual's withdrawal from the partnership or the company;
- 48.3 the asset was used for the business for 1 year preceding earlier of (i) the material disposal or (ii) the cessation of the business.
49. Relief will be reduced to reflect non-business use in the period of ownership (section 169P TCGA 1992).

Relevant business assets

50. The relief is restricted to assets including goodwill used for the purposes of the business carried on by the partnership or the company but excluding shares and securities and other assets which are held as investments (section 169L TCGA 1992).

OPERATION OF THE RELIEF

Claim

51. The relief needs to be claimed (jointly by trustees and the Beneficiary where relevant) within the first anniversary of the 31 January following the tax year in which the disposal is made i.e. for a disposal in 2009-10 by 31 January 2012.

Calculating relief

52. Losses on the qualifying business disposal must be set against gain on the qualifying disposal. That would seem to relate to the same qualifying business disposal and not disposals qualifying for ER relief generally. The resulting gain is then subject to charge at 10% provided that the individual or Beneficiary's total lifetime ER gains is less than £10 million.

Interaction with other provisions

53. Section 169N(9) TCGA 1992 provides that:

"Any gain or loss taken into account under subsection (1) is not to be taken into account under this Act as a chargeable gain or an allowable loss."

54. Query the effect of this on other provisions e.g. section 86 TCGA 1992?
55. What about section 12 TCGA 1992 (the remittance basis)? If it is intended to remove the relief where the remittance basis is claimed (as was the case for taper relief), how is this consistent with EU law?