10 WAYS YOU CAN LOSE YOUR ENTREPRENEURS' RELIEF

Taxation

May 2014

Tolley® Tax intelligence from LexisNexis®

Produced by Taxation Magazine

Written by Richard Holme and Elizabeth Robertson.

Power of 10

Problems to avoid if you want to claim entrepreneurs' relief

KEY POINTS

- The criteria for ensuring that a company is trading.
- Problems with property: how is it held and what is it used for?
- The definition of ordinary share capital and voting rights.
- Income tax advantages can result in increased capital gains tax.
- Ensure that claims are made within time limits.

Capital gains tax entrepreneurs' relief has been with us since 2008 and practitioners will, by now, be aware of its main features, most of which will need to be satisfied in a 12-month run-up to a disposal.

Gains of £10m in an individual's lifetime can qualify for the 10% rate of capital gains tax rather than the normal 28%, so the stakes are high with up to £1.8m of tax (£10m gains at the differential of 18%) at stake if the adviser and his client do not arrange matters carefully and plan in advance.

The eight pages of legislation (TCGA 1992, s 169H to s 169S) have changed little and indeed there have been relatively few tribunal or other cases.

This article sets out 10 problem areas and how the adviser may resolve them with his client ... in good time before a disposal.

1. Is the company trading?

The question of whether a company is trading has long been a moot point for advisers and for capital gains tax purposes. A trading company is defined in TCGA 1992, s 165A(3) as a "company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities".

It has always been understood that HMRC will regard any activity as not being substantial if it comprises less than 20% of the company's activities.

The adviser should not just look at the company's balance sheet and level of assets, but must also consider turnover, profit and the number of employees engaged in trading and non-trading activities.

Sometimes it will be abundantly clear that there are non-trading activities where, for example, the company has purchased investment property or quoted shares. In other cases, it will be less easy; such as when substantial levels of cash have built up from successful trading activities.

It may be easier to justify that this cash surplus is needed for trading operations in the case of a longer established or growing business. The need for the retention of cash for future business use can then be more easily justified than in, for example, the service company where perhaps the only income is consultancy fees with expenses at a minimal level.

In that case, the shareholder may be well advised to take dividends from the company to reduce the cash balance. Generally, and where appropriate, indicating that cash is needed for future trading activities in both the directors' report and directors' minutes will be helpful.

We have successfully used the non-statutory business clearance service (NSBCS) to confirm with HMRC that a company has trading status particularly where cash balances are significant but needed for valid trading purposes (HMRC's Capital Gains Manual at CG64100).

This gives certainty to shareholders, although it should be noted that the NSBCS can only be used by the company rather than by a concerned shareholder.

2. The right type of trusts

Although many families have chosen to use discretionary trusts to maintain flexibility and preserve wealth, such trusts will never be entitled to entrepreneurs' relief. This exclusion also applies to the estates of deceased persons.

However, in this scenario, advisers should be proactive and may choose to recommend to their clients that they change the status of discretionary trusts to a life interest trust (perhaps on a revocable basis to maintain flexibility) to maximise the relief. (An added benefit may be to reduce the overall income tax rate on distributed dividends accruing to the trust.)

Although the matter needs to be treated with some care because there are several other conditions to satisfy, no immediate tax charges should arise under this scenario. In the case of the estates of deceased persons, the capital gains exposure may not be too high anyway due to the revaluation of the relevant asset on death. However, executors should otherwise look to transfer shares out to beneficiaries who would qualify for the relief.

3. Review that structure!

For historic reasons, a family may have chosen to hold, say, agricultural land through a limited company with a view to perhaps keeping taxation of rents or other farming income at a low level.

Although limited companies long term will be paying corporation tax at only 20% and hence gains on land sales (eg for development) will be taxed initially at a relatively benign rate, there will be further significant tax charges on distribution to shareholders (perhaps by way of dividend).

In that scenario, clients have chosen in some cases to distribute land from the property company by means of a dividend in specie (free of SDLT) such that longer-term growth accrues for the benefit of individual shareholders who, with planning, can claim entrepreneurs' relief.

4. Furnished holiday lets

Historically, significant tax benefits have arisen from the ownership of furnished holiday lets, whether in the UK or EEA. Sometimes, losses might be made due to, for example, repairs or finance costs and, up to 5 April 2011, these could be offset against other income and gains under ITA 2007, s 64.

Advisers should remember that there are still other advantages from holding furnished holiday lets, including the claiming of entrepreneurs' relief. There are detailed conditions to satisfy in ITTOIA 2005, s 323 in terms of occupation and use. If these cannot be satisfied, perhaps the property owner can provide other supplementary activities, for example laundry and catering, such that the activities constitute a trade under general principles.

Possibly, the property owner also uses the holiday let as a second home and, in that instance and with appropriate elections, it may also be possible to claim a measure of only or main residence relief under TCGA 1992, s 222 such that the overall tax rate on sale is less than 10%.

5. Avoid charging a rent?

Many business owners will often choose to own the business premises outside the risky trading venture. Quite possibly, they will have borrowed to fund the purchase and need funds to service the mortgage.

It is tempting, therefore, for the business to pay a rent to the property owner. However, to the extent this has been done since 6 April 2008, entrepreneurs' relief will be reduced.

Advisers will need to review all clients in this situation and consider other more tax-effective means of withdrawing funds from the business to pay for the interest.

If there are other properties and no rent is charged, the excess interest on the business premises could, for example, be offset against the other rentals from the proprietor's property business.

6. Investments and trades

Advisers may be approached by a new client who, on the face of it, has been an investment company for a number of years.

However, closer review may reveal that the trading activities ceased within the past three years and hence, on a sale or winding up, shareholders can claim entrepreneurs' relief. In this situation, we have seen scenarios where shareholders have resigned as directors or office holders and the relief has inadvertently been lost.

7. The definition of share capital

To claim entrepreneurs' relief, an individual must have at least 5% of the ordinary share capital and 5% of the voting rights. It is important that advisers focus on the definition of "ordinary share capital" because it may include not only shares described as "ordinary" but also embrace, perhaps, participating preference shares.

A careful review may be needed in some cases to ensure that the 5% test is met.

The settled view of HMRC is that they will look at the nominal value of the shares concerned rather than the number of shares in issue.

Share capital for this purpose is defined in TCGA 1992, s 169S(5) as having the same meaning as in ITA 2007, s 989 namely:

"'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."

The adviser may use this mechanism to the shareholder's advantage. It may be possible to plan such that, although an individual receives less than 5% of the sale proceeds of a company sale, entrepreneurs' relief is available because they have 5% or more of the ordinary share capital, as defined, and indeed have 5% or more of the votes.

The 5% test will need to be met right up to the point of disposal and the adviser will need to take care that, say, the exercise of share options on the day of a disposal does not reduce his client below the vital 5%.

8. A spouse's shareholdings

A key requirement for the 12-month period before a disposal is that the shareholder has at least 5% of the ordinary shares and voting rights and is a director, office holder or paid employee.

There may be a temptation in the family company for the shareholder to transfer shares to a spouse, perhaps with a view to minimising tax on dividend income. It is important in that scenario that the transferee spouse is a director, officeholder or paid employee.

In addition, shareholdings of spouses are not aggregated at all and if, let's say, the husband earns 4% and the wife 4%, although the combined holding is 8% this is not sufficient for either to claim the relief.

Our view is that it is important that, if the shareholder is an employee rather than an officeholder, the employment is paid to add reality and substance to the arrangement. Unpaid employments are rare, except in the not-for-profit sector.

9. Investment partnerships

In private equity and indeed other situations, investment partnerships may own shares in various trading companies and work hard to turn them round and sell them for a large profit in a few years.

The individual partners may take care to ensure that they qualify potentially for entrepreneurs' relief on a sale by being officeholders or employees of the underlying company.

However, there is a danger that their interests will be treated as an investment asset since prima facie they are acquiring an interest in an investment partnership and hence will not qualify for relief. The only exception to this may be where the investment partnership invests in only one trading company.

Private equity investors need to bear this in mind when structuring operations, although often the ownership of the underlying investments will be sufficiently fragmented that the 5% threshold is not attained.

10. Claim on time

As with most reliefs, entrepreneurs' relief must be claimed within the statutory time limit of the first anniversary of the 31 January after the tax year in which the qualifying disposal is made (TCGA 1992, s 169M).

The risk area for the adviser (and his client) will be that not all clients are timely (!) in providing information and hence the time limit might be missed. Although that limit can be unforgiving, there are more complex areas technically to consider for two categories of taxpayer where the charge to UK tax on a capital gain may be contingent upon later events:

A temporary non-resident may make a gain qualifying for entrepreneurs' relief in a year of non-residence, but be charged in the year of return to the UK. Unfortunately, here it is clear that a protective claim should be made for the year of disposal within the normal time limit, even though the gain is charged to UK tax only in the year of return.

Similar principles apply to non-domiciled, remittance-based users who make a capital gain on an overseas business asset, but do not remit this to the UK until a significantly later year.

Entrepreneurs' relief again needs to be claimed within the statutory time limit and this will pertain to the year of disposal rather than the year of charge to UK tax, when remitted.

Conclusion

Ensuring that assets qualify for capital gains tax entrepreneurs' relief can result in substantial tax savings, but advance planning is required to ensure that the relief will definitely be available on disposal.

Delaying a consideration of the relevant factors until the asset is about to be sold or gifted may mean that it is too late to ensure that the tax rate is reduced from 18% or 28% to a more attractive 10%.