Taking the tests

Michelle Robinson explains the changes to the 5% test for capital gains tax entrepreneurs' relief.

HMRC has published brief guidance on the changes made to the 5% test for entrepreneurs' relief that were first announced in the 2018 Budget on 29 October 2018, and amended on 21 December 2018. This test is relevant to individuals who own shares in trading companies in which they are employees or directors. The position of trusts has not changed beyond the conditions the individual must personally satisfy to be an eligible qualifying beneficiary. Trusts are therefore not considered further in this article.

The changes to the 5% test have been incorporated into the personal company definition in TCGA 1992, s 169S and the newly published departmental guidance is in the *Capital Gains Manual* at CG64050 and CG64051.

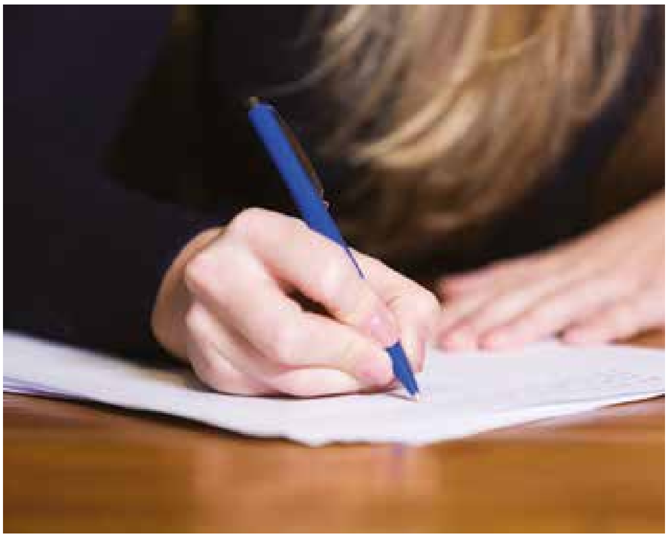
> "The changes to the 5% test have been incorporated into the personal company definition."

Two other key changes were enacted by FA 2019, which generally apply from 6 April 2019. These are listed below for completeness but, again, are not considered further here.

- An increase in the minimum period over which the entrepreneurs' relief conditions need to be satisfied from 12 months to 24 months.
- Individuals can now retain entrepreneurs' relief on the gain accrued on shares and securities up to the point a shareholding reduces below 5% due to a company issuing further shares for genuine commercial reasons as long as specific conditions are met. An election is required.

Key points

- The original share capital and voting tests remain.
- A new economic test applies to disposals from 29 October 2018.
- As well as the original tests, new conditions consider amounts available for distribution and sale proceeds.
- Determining the order of application of the tests.
- An example of the rules in practice.
- The position may need to be considered at the end of the accounting period, which will delay confirmation of entrepreneurs' relief entitlement.
- Sale proceeds are determined using the market value of the ordinary share capital at the disposal date.
- Care is required when dealing with preference shares.



The shareholding test

From its introduction on 6 April 2008 until the Budget 2018 changes, the 5% test that determined an individual's eligibility for entrepreneurs' relief was made up of two factors. The individual needed to:

- own at least 5% of ordinary share capital, measured based on nominal value; and
- be able to exercise at least 5% of the voting rights in the company by virtue of the ordinary share capital holding.

These parts of the entrepreneurs' relief conditions have not changed, but Budget 2018 introduced an economic test, in addition to the above conditions, which affects disposals from 29 October 2018.

In all cases, individuals, as well as meeting other conditions throughout the two years before disposal, must hold at least 5% of the ordinary share capital issued by the company, and that ordinary share capital must confer at least 5% of the voting rights in the company (as before the Budget 2018 changes) and either:

1. beneficially entitle the individual to at least 5% of the amounts available for distribution to equity holders, and at least 5% of the assets available for distribution to equity holders on a winding up; and/or
2. in the event of a disposal of the entire ordinary share capital in the company, entitle the shareholder to at least 5% of the sale proceeds, assuming the effect of any avoidance arrangements entered into with a main purpose of falling into or out of any aspect of the entrepreneurs' relief rules are ignored when calculating whether or not the 5% test is met.

In this article, condition 1 is referred to as the 'equity holder condition', and condition 2 as the 'sale proceeds condition'. These conditions are referred to collectively as the 'economic conditions'.

The equity holder condition

The equity holder condition was the first of the two economic conditions to be introduced, being announced on and applying with immediate effect from 29 October 2018.

The equity holder condition can be difficult to satisfy in many cases. The sale proceeds condition was introduced to assist in such circumstances and is considered later in this article.

The order of the conditions

So which economic condition should be considered first? In the *Capital Gains Manual* at CG64050 HMRC states:

> 'Condition (i) [the equity holder condition] should apply for companies with a single class of issued shares that gives each holder the same rights.'

HMRC's advice is that the equity holder test should be considered first if a company only has a single shareholding, but that in other cases the sale proceeds condition should be considered first. In practice, it does not matter which economic condition is considered first if there is a single shareholding (assuming there are no non-commercial loans in place) because such shareholdings should satisfy both conditions.

Only one condition needs to be met, so whichever is the simplest to apply in the particular circumstances should be considered first. This will usually be the sale proceeds condition.

Definition of equity

The definition of equity is the corporate tax group relief definition, subject to some modifications (as legislated in TCGA 1992, s 169S(3D) and (3E)). The modifications to the corporate tax definition of equity holder for entrepreneurs' relief purposes are succinctly summarised in CG64051 (tinyurl.com/HMRC-99736).

Because the other entrepreneurs' relief conditions refer to 'ordinary share capital', the importation of the corporate tax definitions of 'equity' and 'ordinary shares' can give rise to some conflict between the different definitions. There are two particular problem areas with the definition of equity – ordinary shares and loans – as summarised below.

Ordinary shares

- Ordinary share capital is relevant to all aspects of the entrepreneurs' relief conditions other than the equity holder condition, and is the familiar, and simpler, ordinary share capital definition in ITA 2007, s 989; which is: '...all the company's issued share capital ... 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'.
- 'Equity' includes ordinary shares, as defined for corporate tax purposes. Ordinary shares for this purpose are any shares that do not meet the detailed definition of restricted preference shares in CTA 2010, s 160 and others.
- Some shares that are ordinary share capital under the s 989 definition may not be ordinary shares for the purposes of the equity holder condition, and vice versa. This creates complexity in practice. Preference shares, in particular, need careful consideration.

Loans

- 'Equity' also includes loans other than normal commercial loans.
- In particular, equity includes loans which entitle the lender to more than a reasonable commercial rate of return on amounts lent.
- Loans on which the company pays equal to or less than a commercial rate of return, are not equity for entrepreneurs' relief purposes. This means that interest-free loans to companies do not affect the entrepreneurs' relief position of shareholders.
- Loans made to a company by a person carrying on a banking business in the ordinary course of that business are not treated as equity for entrepreneurs' relief purposes.

The different definitions of 'equity' and 'ordinary share capital' can result in individuals having different percentage shareholdings for the purposes of the equity holder condition in comparison with the remainder of the entrepreneurs' relief conditions. The following example of 'A and B shares' illustrates the interaction between the ordinary share capital and equity holder definitions.

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A and B shares

A trading company has two classes of ordinary £1 shares in issue: A and B shares. The A shares carry one vote per share, entitle shareholders to assets on a winding-up in proportion with the number of shares held, and can receive distributions at the directors' discretion.

The B shares entitle the holder to receive a distribution of £10,000 if the company's profits are below a specific level, assuming the company has sufficient distributable reserves to pay this. Distributions in excess of £10,000 are divided equally between the A and B shareholders. The B shares carry one vote per share, but do not entitle the holder to receive distributions of assets in the event of a winding-up.

The shares in the company are held by two long-standing directors of the company; Mr Y and Ms X. Both shareholders have held their shares for several years, and there have been no changes to the share terms, nor to the number of shares they each hold. See ***Company Shareholdings***.

Company Shareholdings

Individual	A shares	B shares	Total number of shares	Percentage interests
Mr Y	50	0	50	25%
Ms X	50	100	150	75%
Total	100	100	200	100%

On the face of it, Mr Y and Ms X both appear to easily qualify for entrepreneurs' relief because they each hold more 5% of ordinary share capital, voting rights and equity. However, the equity holder condition is not a test of the percentage interest held; it is a test of the extent to which the equity entitles the holder to distributions and assets on a winding-up.

Dealing first with entitlement to the distribution of assets on a winding-up, only the A shareholders are entitled to this. Because Mr Y and Ms X each own 50% of the A shares, they both satisfy this element of the equity holder condition.

The B shareholders have a priority distribution right if profits are less than a set level. The equity holder tests require consideration of the company's profits at the end of each accounting period that is relevant to the individual's tax position.

In this example, it is assumed that, throughout the accounting periods in the two years before Mr Y and Ms X dispose of their shares, the company's profits are such that a distribution of £10,000 can be paid to the B shareholders, and the A shareholders are not entitled to receive a distribution.

> "The equity holder condition must be satisfied by virtue of the individual's ordinary share capital holding."

The position is summarised in ***Distributions*** below.

Mr Y is not entitled to receive a distribution, and therefore fails the distribution element of the equity holder condition. Mr Y is not eligible for entrepreneurs' relief under this condition. His position under the sale proceeds condition should also be considered.

Ms X is entitled to the entire distribution paid by the company, and so satisfies the distribution element of the economic condition. Because Ms X satisfies both elements of the equity holder condition, and because the other elements of the 5% test are met, Ms X is eligible for entrepreneurs' relief using this test.

Application of the equity holder condition

The equity holder condition requires the company's profits – at the end of all accounting periods that cover the two years before disposal – to be applied to determine the extent to which equity holders have a beneficial entitlement to receive distributions. A notional figure of £100 is used if the company reports an accounting loss.

Similarly, the assets on the balance sheet must be used to determine the distributions in the event of a winding-up. This means that assets that are not on a balance sheet, such as goodwill, are not taken into account for this element of the equity holder test. A figure of £100 is used if the liabilities reported on the balance sheet exceed the company's assets so reported.

The requirement to consider the position at the end of the accounting period means that it may not be possible to determine whether a shareholder qualifies for entrepreneurs' relief using this test until several months after the share disposal has occurred.

In practice, there will be circumstances in which the percentage entitlements do not vary depending on the company's profits or net assets; for example, if there is only a single class of shares or the proportionate interests of each class of share are fixed. In such cases, it is reasonable to conclude that the equity holder condition is satisfied without referring to the company's accounts. HMRC's comments in the *Capital Gains Manual* at CG64051 support this approach:

> 'Where a company has a single class of shares in issue and there are no other arrangements that affect any shareholder's rights then this condition is likely to be met without the need to refer to the actual accounts. In other situations [the sale proceeds condition] may be more straightforward to consider.'

Side agreements and further contracts

The equity holder condition must be satisfied by virtue of the individual's ordinary share capital holding (according to the definition of personal company in TCGA 1992, s 169S). When considering whether the equity holder condition is satisfied by virtue of the ordinary share capital, HMRC states that the equity holder condition 'will not be met if there is reliance on a side agreement or further contract'.

Presumably, this is intended to circumvent contractual agreements that individuals may enter into with the intention of satisfying this test. Care should be taken in practice if there are any side agreements or other contractual documents in place.

The sale proceeds condition

The sale proceeds condition will, in practice, often be the simpler of the two economic conditions to apply.

The sale proceeds test also applies to most disposals from 29 October 2018. The exception being that the test only applies from 21 December 2018 for the purposes of the goodwill element of any gain on which the individual has elected to pay tax on at the point of incorporation, under TCGA 1992,

Distributions

Individual	A shares	Distribution receivable	B shares	Distribution receivable	Total distribution receivable	% distribution receivable
Mr Y	50	£0	0	£0	£0	0%
Ms X	50	£0	100	£10,000	£10,000	100%
Total	100	£0	100	£10,000	£10,000	100%

s 169LA. This point is not considered further in this article, but should be borne in mind if relevant.

The sale proceeds condition is satisfied if, were the company to be sold, the individual shareholder's ordinary share capital would entitle them to receive 5% of the sale proceeds of the total amount paid for all of the company's ordinary share capital.

The sale proceeds condition cannot be satisfied if it is only met due to avoidance arrangements that were entered into with a main purpose of any of the entrepreneurs' relief provisions applying or not applying. The remainder of this article assumes that no such avoidance arrangements are in place.

Satisfying the sale proceeds condition

If the entire ordinary share capital of the company is sold, an individual must receive 5% of the sale proceeds to satisfy the sale proceeds condition. Care should therefore be taken if there are any arrangements in place that change the proportionate interests in the event of an exit.

If the entire ordinary share capital is not sold, an individual's percentage interest is determined by considering the amount they would have received if there was a sale of the entire ordinary share capital of the company.

In such hypothetical scenarios, minority discounts are ignored for valuation purposes, a point which is confirmed by HMRC at CG64051 of the *Capital Gains Manual*.

When determining whether the sale proceeds condition is satisfied, the legislation (TCGA 1992, s 169S(3A)(b)) requires:

> 'It is to be assumed that the amount of proceeds to which the individual would be beneficially entitled [to throughout the minimum holding period] is the amount of proceeds to which, having regard to all the circumstances as they existed at [any time in the minimum holding period], it would be reasonable to expect the individual to be beneficially entitled...'

The HMRC manuals state that, because consideration should be given to all of the circumstances surrounding the shares, consideration should also be given to any shareholders' agreements.

The market value used is that of the ordinary share capital at the disposal date. This value is deemed to have been the value of the ordinary share capital throughout the minimum holding period. This is particularly pertinent if terms are in place such that different shareholders have different entitlements on an exit depending on the company's performance including, for example, growth shares.

Application to growth shares

As stated above, if growth shares are in place, the market value of the ordinary share capital on a disposal should be applied to determine whether the sale consideration condition is satisfied. HMRC's example 2 in CG64051 illustrates this point with the scenario of an individual who is eligible for entrepreneurs' relief because the company is sold for a sufficiently high value for him to receive 6% of sale proceeds (on the basis that he meets the other entrepreneurs' relief conditions), even though he would have received less than 5% had the company been sold earlier in the two year minimum holding period, when its value was lower.

Planning point

The requirement to consider the position at the end of the accounting period means that it may not be possible to determine whether a shareholder qualifies for entrepreneurs' relief using this test until several months after the share disposal has occurred.

Other interests in companies

As noted above, the definition of ordinary share capital is the ITA 2007, s 989 definition, so there is no requirement to consider how the interests in a company should be classified for corporation tax purposes.

It is the amount paid or payable for the s 989 ordinary share capital which is relevant to the sale proceeds condition: amounts paid in respect of other interests in the company are not taken into account. For example, if there are fixed rate preference shares in issue, amounts paid in respect of those shares are ignored when determining whether the sale proceeds condition is satisfied.

"It is the amount paid or payable for the s 989 ordinary share capital which is relevant to the sale proceeds condition."

As previously referred to in the context of the equity holder condition, particular care should be taken over shares described as preference shares, which may be ordinary shares for s 989 purposes. This issue has long been relevant when considering an individual's ordinary share capital holding and voting rights, and is also relevant to the sale proceeds condition.

Conclusion

Only one of the economic conditions needs to be satisfied for entrepreneurs' relief to be available. In practice, it will usually be simpler to consider the sale proceeds test first. This may require a company's ordinary share capital to be valued. If this is onerous, it may be worthwhile to consider whether the equity holder condition is satisfied.

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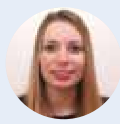

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