

Briefing document

Entrepreneurs' relief and companies

Introduction

Entrepreneurs' Relief (ER) is a Capital Gains Tax (CGT) relief which reduces the CGT rate on qualifying gains made on disposal of eligible business assets from 20% to 10%. Various conditions must be met. Broadly, ER is available to individuals who are actively involved in a business, whether this is a personally owned business, or operated through a partnership or company.

Each individual is able to claim ER on up to £10million of gains in a lifetime, which can result in a tax saving of up to £1million. Trustees can claim ER if certain conditions are met, which include the trust having an interest in a business in which a trust beneficiary is personally eligible for ER.

This note contains a high-level overview of ER as it applies to interests in companies. ER is also available on qualifying interests in businesses carried on by sole traders and by individuals carrying on a business in partnership with others. A separate briefing note on ER in these contexts is available on request.

A different relief, investors' relief, is available in certain circumstances and also results in a 10% CGT rate. Broadly, ER is relevant to individuals who are actively involved in a business and investors' relief is relevant to individuals who are not so involved. A separate briefing note on investors' relief is available on request.

Minimum period over which the ER conditions must be met

- Various conditions must be throughout a minimum period immediately preceding a disposal of shares or securities in order for ER to be available. This period is currently normally 12 months. The 12 month minimum period will increase to 24 months in respect of disposals on or after 6 April 2019.
- ER remains available following cessation of trade, provided the individual's business assets are disposed of within the three years following cessation and the trade was carried on for a minimum period pre-cessation. The minimum period was 12 months for trades that ceased before 29 October 2018, increasing to 24 months with immediate effect for cessations on or after 29 October 2018.
- Different time periods can be relevant in some cases, such as on disposal of personally owned assets used by a trading company.

Conditions that must be met in order to qualify for ER

ER is available on gains made on the disposal of shares or securities in a trading company, or the holding company of a trading group, provided the individual is an officer or employee and meets all three of the following conditions that comprise the "5% test":

1. The individual must own at least 5% of the ordinary share capital in the company, and;
2. By virtue of that shareholding, be able to exercise at least 5% of the voting rights in the company, and;
3. Either or both of the following conditions are satisfied:
 - a. The individual, by virtue of his or her ordinary shareholding, must (broadly) be entitled to receive at least 5% of amounts available for distribution to "equity holders" of the company, and at least 5% of amounts that would be payable to equity holders on a winding up, and/or;
 - b. The individual would reasonably expect to receive at least 5% of the sale proceeds if the entire ordinary share capital of the company was sold for market value, assuming that any arrangements with a main purpose of falling into or out of any aspect of the ER legislation were ignored.

The point around selling the entire ordinary share capital of the company is a valuation method which means that minority discounts that may otherwise apply when valuing an individual's shares in a company are ignored: it is not necessary for the entire company to be sold for this condition to be met.

Condition 3a is a new test that was announced on 29 October 2018, and applies to disposals made on or after that date. The draft legislation was imported from corporate tax legislation and can lead to unexpected results in the context of individuals. Notably:

- The term 'equity holder' encompasses both ordinary shares, as defined for corporate tax purposes, and certain non-commercial loans. The definition of ordinary share imported from the corporate tax provisions differs from the definition of ordinary share capital that applies for the remainder of the ER conditions. This means that individuals may have different percentage interests for the purposes of the different ER tests.
- It may not be possible to satisfy condition 3a if the directors have discretion over on which share class to pay dividends.

Condition 3b was announced on 21 December 2018, but for most purposes is backdated to apply from 29 October 2018. The 21 December 2018 date is relevant to the restriction of ER on the goodwill element of any gain accrued on incorporation of a business – see below.

The potential application of condition 3b will often be more straightforward to assess than the application of condition 3a.

Cessation of trade

ER will remain available following cessation of trade by the trading company in which the individual holds shares and potentially other interests, provided the ER conditions were met for at least 24 months prior to cessation of trade. For cessations prior to 29 October 2018, the company only needed to have been trading for 12 months pre-cessation.

Share exchanges

- In qualifying cases, when shares in one company are exchanged for shares or securities in another company, the capital gain that would otherwise have been realised at the point of exchange may be automatically deferred until a subsequent disposal of the new shares and/or securities. ER will only be available on a future disposal if the individual meets the ER requirements at that time.
- If the individual is eligible for ER at the point of exchange but does not expect to be so eligible on a future disposal, he or she may prefer to elect out of the automatic deferral of capital gain, such that CGT would be payable on the gain realised at the point of exchange. This would enable ER to be claimed on the gain. The deadline for making such an election aligns with the time limit for claiming ER, as set out below.
- Such elections should be carefully considered before being made, particularly with regards to the cash flow impact and the position should a loss arise on a future disposal.

Dilution of shareholding on issue of further shares

- Because the tests for ER need to be satisfied for a two year period prior to disposal, ER could cease to be available if an individual's shareholding is diluted below 5% due to a company issuing further shares.
- From 6 April 2019, if the further share issue is made for commercial reasons, ER will remain available on the gain accrued on shares or securities up to the point an individual's shareholding falls below 5% due to the share issue.
- Retention of ER is subject to the individual making an election to realise a deemed capital gain at the point of dilution. The gain is calculated as though the individual had sold his or her shares and securities for market value, with market value calculated based on the amount that would be receivable if the entire company were sold. As for condition 3b above, this means that the discounts which would normally apply when valuing minority shareholdings are not applicable.
- A further election can be made to defer taxation of the deemed gain until a future disposal of the shares.
- This relief will not be available to trustees, nor will it be possible to make an election in order to claim ER on gains accrued on personally owned assets used by the company (see below).

Personally owned assets used by a trading company

- ER may be available on gains made by an individual on the disposal of personally owned assets used by a trading company for at least 12 months before disposal. For disposals made after 5 April 2019, assets must be used by the company for at least 24 months before disposal.
- For ER to be available, the individual must be eligible for ER on a personal shareholding in the company. ER in this case is only available where the disposal is made as part of the individual's withdrawal from the business and provided the individual also disposes of:
 - At least 5% of the ordinary share capital of the company which satisfy all elements of the 5% test, or;
 - Securities, which constitute at least 5% of the value of securities of the company.

- In addition to the above conditions, the asset disposed of must have been owned for at least three years immediately preceding the disposal.
- Relief is restricted on a just and reasonable basis where:
 - The asset was not used in the business throughout the ownership period, or;
 - The asset was only used partly for business purposes, or;
 - The individual charged the business rent for use of the property.

Trusts

ER is only available on the disposal of trust business assets where an individual is entitled to the income received by the trust from the business assets in question (an 'interest in possession'), and provided that individual qualifies for ER on a personally owned shareholding in the company.

Trustees may be able to claim ER after a company in which they have an interest ceases to trade, assuming that the ER conditions set out above were met prior to cessation of trade.

Lifetime limit

Each individual is able to claim ER on a maximum of £10million of gains in a lifetime, which can result in a tax saving of up to £1million (or £2million for a couple). There is no requirement to use the entire lifetime limit on one transaction; instead ER can be claimed throughout an individual's lifetime as qualifying gains arise.

ER claims on trust gains use part or all of the lifetime limit of the beneficiary who personally qualifies for ER.

Gains realised in excess of the available lifetime limit are taxable at the prevailing CGT rate, which is currently 20% for higher and additional rate taxpayers and trustees on most gains (a 28% rate applies on residential property and carried interest gains).

Claiming ER

ER must be claimed by the second 31 January following the end of the tax year in which the qualifying gain arose. If ER is to be claimed on trust gains, the trustees and beneficiary whose lifetime limit will be used must make a joint election. The deadline to claim ER on gains realised in 2018/19 is 31 January 2021. The same deadline applies to elections that may be made on share exchanges, as set out above.

As noted above, from 6 April 2019, individuals whose shareholding is diluted below 5% due to a share issue will be able to retain ER on the gain accrued up to the point of dilution, subject to making an election. The deadline for this is the usual ER time limit as set out above. A second election can be made to defer the CGT due. The deadline for this election is four years from the end of the tax year of dilution. In practice, it is likely that both elections would be made at the same time, so the aforementioned 31 January deadline is the relevant date.

Points to note

- There is no aggregation of spousal ownership, so if one spouse owns 3% of the ordinary shares and voting rights in a company and the other spouse owns 4%, neither spouse will qualify for relief.
- Part-time workers are eligible for ER, as there are no set rules about how many hours an individual must work in order to qualify for ER. He or she must genuinely undertake at least some work for the business.
- The 5% test does not need to be met in respect of shares acquired through the exercise of EMI options after 5 April 2012. The ownership period for ER purposes is deemed to begin on grant of the EMI option(s).
- Taxation of capital gains can be deferred to a later date when a qualifying Enterprise Investment Scheme (EIS) investment is made. ER can be claimed when deferred capital gains become chargeable, provided the gain was eligible for ER when it was realised and provided the gain was originally realised after 2 December 2014. ER is claimed when the gain comes back into charge. There are a small number of other cases where ER may be available on a previously deferred gain coming back into charge.
- When a business is incorporated and the requisite conditions are met, no chargeable gain is triggered on the disposal of the individual's interest in the business in exchange for shares in a new company. Instead, the individual will be liable to CGT if they realise a capital gain on an eventual disposal of their shares.
- It is possible to opt out of this automatic relief on incorporation, which may be preferred if ER is available at the date of incorporation, but is unlikely to be available in the future. ER is restricted in some circumstances to the extent that a gain realised on incorporation relates to goodwill and the individual satisfies any aspect of the 5% test.

Find out more...

This note reflects the law in force as at 1 March 2019. Please be aware that this note does not cover all aspects of this subject. To find out more about any aspect of the above, please discuss with your usual Deloitte contact. If you do not have a usual contact, please contact Michelle Robinson (michellerobinson@deloitte.co.uk).

For further information visit our website at www.deloitte.co.uk.

This publication has been written in general terms and therefore cannot be relied on to cover specific situations; application of the principles set out will depend upon the particular circumstances involved and we recommend that you obtain professional advice before acting or refraining from acting on any of the contents of this publication. Deloitte LLP would be pleased to advise readers on how to apply the principles set out in this publication to their specific circumstances. Deloitte LLP accepts no duty of care or liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 1 New Street Square, London, EC4A 3HQ, United Kingdom.

Deloitte LLP is the United Kingdom affiliate of Deloitte NWE LLP, a member firm of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"). DTTL and each of its member firms are legally separate and independent entities. DTTL and Deloitte NWE LLP do not provide services to clients. Please see www.deloitte.com/about to learn more about our global network of member firms.