Share Disposals: Entrepreneurs' Relief and Investors' Relief

Anthony Newgrosh
& David Simpson

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Entrepreneurs' relief and investors' relief

- Various changes made in the Finance Act to the legislation governing entrepreneurs' relief (ER)
- Introduced in FA16 with a minimum three-year qualifying period, the first potential claims to investors' relief (IR) can be made from 6 April (2019)

Entrepreneurs' relief

Familiar rules:

- Employee or director (shadow director?)
- In a trading company (high bar definition)
- Holding 5% of the ordinary share capital (unless acquired by way of the exercise of an EMI option)
- With 5% of the voting rights by virtue of that holding

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ER: old chestnut 1

Trading company

- Not the 51% test
  - A company 'whose activities do not include to a substantial extent activities other than trading activities'
  - Excess cash issue
- The three-year look back 'get out of jail' card

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ER: old chestnut 2

Ordinary Share Capital

All 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”

- What about shares with no entitlement to a dividend (or a fixed rate of zero)?
- Fixed rate preference shares with a token coupon (e.g. 0.00001%)
- 10% fixed rate preference shares, non-cumulative
- Cumulative 10% prefs entitled to premium on redemption, sale or liquidation

ER changes

- Qualifying period
- Relief for dilution below the qualifying 5% threshold due to cash subscription for shares (i.e. a funding round)
- Alteration to the 5% test itself

Dilution relief

Two new elections possible:

(i) Crystallise a notional disposal and re-acquisition on the dilution event (based on a fractional valuation)

Creates a dry charge – eligible for ER – and a step up in the tax base of the shareholding

(ii) A further election can postpone recognition of the gain arising on the notional disposal until the shares are actually sold

BUT, the second election only deems the 5% rule to be satisfied at that later time; still need to satisfy the other rules for ER (if it still exists) to get the 10% rate on the frozen gain

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5% changes to ER

Introduction of economic interest test into 5% rule:

Either

‘that the individual is beneficially <u>entitled</u> to at least 5% of the profits available for distribution to <u>equity holders</u> and, on a winding up, would be beneficially entitled to at least 5% of assets so available’

Or

‘in the event of a disposal of the whole of the <u>ordinary share capital</u> of the company, the individual <u>would</u> be beneficially entitled to at least 5% of the proceeds’

Deeming provision for ratchet mechanisms

Investors' relief

ER : IR : (S)EIS

- 10% rate on qualifying gains realised after 5 April 2019
- £10m lifetime cap on qualifying gains – like ER – but standard spousal transfer provisions – unlike ER – so effective £20m allowance for a couple

Investors' relief

Conditions

(i) Subscription in cash into ordinary share capital

(ii) From 17 March 2016

(iii) Trading company (high bar) throughout the period of ownership; but no restrictions on the nature of that trade

(iv) Can become an unpaid director following subscription (EIS type restrictions) or, after six months, an employee

(v) Minimum holding period of three years

(vi) EIS type 'value received' anti avoidance for those three years

Investors’ relief

- Can it be used in conjunction with ER given the permitted director/employee provisions?
- Why not claim EIS instead, given the subscription requirement?

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Investors' relief

ER & IR together

- Yes! See CG 63560

Non HMRC example

Individual subscribes for 15% of the ordinary share capital of a qualifying company. Becomes a director following subscription

On exit, three years later, anticipated gains of £30m:

- ER on £10m relating to first 5%
- IR on £10m relating to second £10m
- $\frac{1}{3}$ pre-sale transfer to spouse who claims IR on that £10m

Investors' relief

Why not claim EIS instead on previous example?

- Broad topic requirements for EIS in s.286(3) ITA now runs from ss (za) to (m); that's 21 general areas which can disqualify an investment
- Excluded activities (includes trades linked to land)
- Gross asset requirement (£15m)
- Company age requirement
- Number of employees test and skilled worker rules
- Risk to capital requirement; financial health rule