# Entrepreneurs' relief

## General overview

Entrepreneurs' relief (ER) provides relief for disposals by smaller business owners. It results in a tax rate of 10% on the disposal.

The relief is available on material disposals of business assets which covers businesses operated as a sole trader, partnership or through a limited company. There is also a form of relief for businesses owned within a trust, by reference to the beneficiaries of the trust, although this will not increase the amount of relief available over and above that for an individual owner.

The maximum gain to which relief can apply is a lifetime limit of £10 million. The lifetime limit works so that an individual making a number of disposals of businesses during his lifetime may exceed the limit. The value of the relief is therefore £10 million x 10% (the maximum reduction in tax) = £1,000,000. This should be borne in mind when considering appropriate planning steps, as they may have negative consequences of ER.

The conditions for relief and operation of the relief differs slightly for the three types of business entity, so they will be considered separately.

## ER - impact on sole traders

The relief is available in two situations applying to sole traders:

- The sale of all or part of the business, and
- The sale of assets which were used in a business which has ceased trading within the last three years.

## What is a business?

The law defines business as any trade, profession or vocation, carried on on a commercial basis with a view to profit, and extends this definition to include furnished holiday lettings, which normally attract the more beneficial treatment accorded to business assets by capital gains tax rules. It is important to note, therefore that other letting activities, whether residential or commercial do not qualify as business activities for the purposes of this relief.

The relief includes a condition that the business has been operated for at least 12 months prior to the disposal.

## All or part of the business

The relief is intended to meet the needs of those disposing of businesses, and not those merely selling assets so the qualification is that the trader either sells the whole business, or a distinct part of the business as a going concern, or ceases trading completely, or in one particular aspect of his business activities and sells the assets relating to that.

In considering whether a particular business activity has separable parts, it is likely that HMRC will use test cases under an old relief known as retirement relief. Although this relief was withdrawn a few years ago, the entrepreneurs' relief is very closely modelled on the terms of retirement relief, so the old cases will very likely be a good place to start.

**Example**

A farmer has made extra money over many years by selling off small plots of land to adjoining properties as extra garden. He was previously able to take taper relief on these disposals, reducing the CGT charge. However, no relief is available under ER as he is not selling all or a distinct part of his business. He would need to cease trading completely to qualify for relief.

As an alternative, he may have some established stabling and livery activities on a small field. If he were to either sell this part of his farming activity as a going concern, or to cease this activity and sell the field and stables (possibly for redevelopment) he would be able to claim relief in relation to the cessation or disposal of a distinct part of his business.

**Incorporation**

There is no restriction in relief if the business is sold to a connected party, except where the business is disposed of to a related company so ER will be available on the sale of the business as a going concern to a company owned by the individual, but not in relation to any goodwill sold; so any gains on a property passing into the company on incorporation would be covered by ER, but the value of goodwill would not. Where goodwill has significant value and is regarded as "separable" from the individual personally, other reliefs are available which may reduce the tax charge on incorporation.

**ER - impact on partnerships**

The sale of all or part of a partner's share of his interest in a partnership will attract ER to the extent that the sale generates a capital gain. The treatment of goodwill in partnerships is a complex issue and subject to HMRC guidance, so making general comments about this area is a little risky, but provided such a sale is taxed as a capital gain, the ER will apply to the disposal.

As for sole traders, the partnership can be carrying on any trade, profession or vocation, including furnished holiday letting activities, but the relief will not be available when the partnership is merely an investment vehicle, such as one which lets property other than as furnished holiday lettings. The partner making the disposal must have been a member of the partnership for at least 12 months prior to the sale to qualify for relief.

If a partnership incorporates, the same limitation applies in relation to ER on the partnership goodwill. In this case, any partners leaving the firm on incorporation will be permitted to claim ER on the disposal of their portion of goodwill, but the remaining partners will not.

**Associated disposals**

There is also relief available in a partnership environment for the sale of an asset owned personally by one or more partners (i.e. not by the firm as a whole) when they withdraw from the business. This is termed and "associated disposal" and is dealt with separately here. It provides extended relief when for example, the partnership premises are owned privately by one partner, who disposes of the premises on his withdrawal from the partnership. He must dispose of at least 5% of the partnership assets to be able to access the material disposal relief.

**ER - shareholders in companies**

Relief is available on the disposal of shares and other securities in limited companies provided that the various conditions relating to this type of disposal are met.

**The company**

The company must be a trading company or the holding company of a trading group in the 12 months leading up to the date of disposal. The definition of a trading company is based on the activities the company carries on. A trading company is a company which carries on trading activities and to no substantial extent carries on activities other than trading activities. Companies which are partners in a partnership which carries on a trade do not qualify unless the company also trades in its own right.

This test has been in use for some time, and we have had guidance about the interpretation of the test from HMRC for a number of years, although the interpretation of the guidance has never been tested in court. Essentially if a company carries on only trading activities and has no investments on the balance sheet it will meet the definition. Once there are assets on the balance sheet which constitute investments, the company must consider the "to no substantial extent" test. The guidance indicates that this is a 20% test, and that in considering it HMRC will consider the time spent by the directors of the company on the various activities, the income received from the activities and the value of assets held in relation to those activities. Large cash balances were considered to be a problem historically, but if the cash is not actively managed and is derived from the trade it is possible to argue that this does not constitute an activity as such.

**The ownership of the company**

In order to qualify for relief the disposer must own at least 5% of the ordinary share capital of the company, which must entitle him to at least 5% of the votes. The disposer must also be an officer or employee of the company, and all conditions must be met for at least the 12 months leading up to the disposal.

Once the conditions have been met, the disposer is at liberty to dispose of any shares or securities (including loan notes) in the company provided these meet the definition of securities, however long they have been held. Relief would extend to shares owned for a much shorter period, provided that the base level of 5% has been owned for a minimum of 12 months (and the officer / employee test has also been met for the same period).

**Winding the company up**

Where it is intended to cease trading and wind the company up by striking it off as inactive, the relief can still apply provided:

- the distribution of the assets is taxed as a capital distribution and not income
- the distribution takes place within three years after the company ceased trading
- the relevant conditions were met in the 12 months prior to the cessation of trade by the company.

This allows those with smaller businesses operating through limited companies to take relief when winding up their company through a striking off and distribution of the assets. Such distribution is taxed as capital if less than £25,000 and as income if more than that amount. This applies to striking off only. If the distribution of assets exceeds the £25,000 limit, a liquidator must be appointed in order for the capital treatment to be secured. There are additional restrictions imposed to prevent "recycling" companies by liquidating one company and starting up another doing largely the same thing, or ceasing a company and restarting the same business as self-employed or through a partnership.

**Special rules in relation to shares**

Where the owner of a company is bought out by another company in which he receives shares in exchange, the relief may in future be compromised when the shares received are less than 5% of the share capital of the new parent company.

In this case, the terms of the new relief allow the disposer to elect that the rules on take-overs should not apply. This would mean that the disposal of his shares would be treated as triggering a capital gain to which ER could apply, rather than being treated as rolling the cost of the old shares into the new shares.

This convenient election means that if he chooses, a company owner might elect to pay the tax due on the initial disposal to ensure that he benefits from relief. However, he would be faced with a tax bill of 10% of the gain, which he may not have the funds to meet. The election would not allow him to defer the tax payable, so this is one of the key downsides to this provision.

**Disposal in return for qualifying corporate bonds (QCBs)**

Further business reorganisation provisions allow for a disposal which qualifies for ER but under which QCBs are acquired to be treated as if the ER is applied to the gain on the initial disposal, so that on a subsequent disposal of the QCBs the gain treated as arising at that point is the gain after ER.

**Reinvesting the gain in EIS shares**

If an investor in an EIS share issue has capital gains in the year of investment, he can treat those gains as "rolled into" the EIS shares, and the gain is deferred until the EIS shares are sold, with ER applying to the original gain when it crystallises. This relief is known as reinvestment relief and is subject to many conditions.

**Associated disposals**

Where premises occupied by the company are owned personally by a shareholder then relief may also be available on the gain on disposal of the property, provided the disposal is made after the shares have been sold and the individual withdraws from the company. This is a very common scenario and is an important aspect of the relief. More details of this are here

**ER - associated disposals**

The relief available on associated disposals is more complex than the basic relief, and is applicable after the relief available in respect of the disposal of shares of a minimum of 5% of the shares in the company or of at least 5% of the partnership assets in case of a partner in a firm. The rules are relaxed slightly when the business is genuinely being sold in full.

An associated disposal of business assets is the disposal of assets owned by an individual and used in a business carried on by a company or partnership in which the owner of the asset has made a material disposal as a result of withdrawing from the business.

It is very common when trading through a limited company to retain the premises from which the company trades in private ownership. This is quite often the only way in which finance to purchase the premises can be secured.

The disposal of the premises (or other asset) must take place after the material disposal - that is the disposal of the business itself - otherwise no relief will be available. Once the disposal of the business has been made, then provided for the period of 12 months ended with the earlier of the disposal of the interest in the business, or the cessation of business of the partnership or company the asset was in use for the business of the company or partnership then relief may be available.

**Restrictions on relief**

Full relief would be available on the gain (subject to the £10 million limit) only where the asset has been used wholly in the business rent free throughout its entire period of ownership. If the asset has been used for other purposes, or rent has been charged, then the relief may be restricted.

Where the asset has been used for other purposes either in part or in full at some time during its period of ownership, the gain on disposal will be apportioned to exclude from relief the amount relating to the non-business use - either on a time basis or another apportionment if only part of the asset was used for the business.

With regard to rent, only rent charged on or after 6 April 2008 will be taken into account when restricting relief, but where rent has been charged since that date the rent actually charged will be compared to the market rent for the property. A pro rata adjustment will then be made to block relief on the part of the gain represented by the proportion of rent charged.

**Example**

If the rent charged after 6 April 2008 was full market rent, then none of the gain after that date would qualify for relief. The gain would need to be time apportioned, and the amount relating to the post April 2008 excluded from relief.

If the rent charged after 6 April 2008 represented only 20% of the market rent, then 20% of the gain post April 2008 would be denied relief. So if a property is sold at a gain on £1 million on 1 June 2015 and has been owned and used by the company for 20 years, the following computations would apply:

Full market rent throughout: Gain attracting ER (up to April 2008) 153/240 months = £637,500. The balance of £362,500 is fully taxable.

Rent reduced to 20% of market rent from 6 April 2008: ER gain (as before) £637,500. Partial relief - balance of gain is relieved by 80%, fully taxable element 20% = £72,500

As a result, owners of property used by their company or partnership will need to consider whether it is appropriate to charge rent on the property. This is a very complex issue which warrants detailed study based on the full facts and intentions of the business owner.

**We would be happy to provide further advice if needed.**