

Bird & Bird

Entrepreneurs' Relief ("ER")

Introduction

Entrepreneurs' Relief ("**ER**") allows office-holders and employees to benefit from a 10% tax rate on capital gains if certain conditions are met. ER is due to be re-named "**Business Assets Disposal Relief**" but we will continue to refer to it as ER in this fact sheet.

This fact sheet deals with ER on the disposal of shares by individuals in the UK. ER also applies to disposals of businesses and assets used in businesses but these are not dealt with here.

The rate of capital gains tax is 20% (or 10% for individuals with income and chargeable gains below the higher rate income tax threshold of £50,000 for 2020/21). An individual who qualifies for ER, by contrast, is taxed 10% on chargeable gains up to a lifetime limit of £1 million (for disposals on or after 11 March 2020). ER is therefore a valuable relief for higher rate tax payers as it enables individuals to save up to £100,000 of capital gains tax.

Conditions

For an individual to qualify for ER, throughout the period of two years ending with the date of disposal, the following conditions must be met:

- a The company must be the individual's "**personal company**"

A personal company is a company in which the individual holds at least 5% of the ordinary share capital (when tested by nominal value) and 5% of the total voting rights.

In addition there are two "**economic**" tests for disposals after 29 October 2018. Either (a) the individual must be entitled to at least 5% of the sale proceeds on a disposal of all the ordinary share capital, or (b) to at least 5% of profits available for distribution to all equity holders and 5% of net assets available to equity holders on a winding-up. The 5% of sale proceeds test is applied on the day of sale and is (broadly) treated as met for the prior two years.

Ordinary shares are (broadly) all shares in issue other than fixed rate preference shares¹.

Equity holders are (broadly) all shareholders (other than certain limited types of preference share) and all loan creditors (except for normal commercial loans). The definition is complicated but preference shares and creditors with (in both cases) conversion rights or rights to acquire shares or securities are equity holders for these purposes.

¹ A fuller definition of "ordinary shares" (although still paraphrased slightly) is all the company's issued shares by whatever name called other than shares which give the holder a right to participate in a dividend at a fixed rate but which have no other right to share in the company's profits.

ER applies to "interests in shares" as well as shares so jointly owned shares can qualify. The legislation requires an apportionment, however, where shares are held jointly so as to treat the holder as the beneficial owner of only so many shares as is "proportionate to the value of the individual's share" for the purposes of the 5% tests.

If a company has shares under option these are often exercised immediately before an exit by way of a sale. The issue of additional shares immediately prior to completion may cause other holdings to be reduced to below the 5% threshold immediately prior to disposal. The 5% tests must be met for two years prior to "the date of" disposal. HMRC have confirmed (at ICAEW Tax Faculty Guidance Note, Example A7) they do not consider the issue of shares on the day of sale to cause the test to be failed in these circumstances. Unfortunately HMRC guidance (at CG64051) on the new economic sales proceeds test suggests "relief is not available where someone's shareholding is diluted below the required level before disposal".

- b The individual must be an officer or employee of the company (or a company in the same trading group)

There is no minimum number of hours that an employee is required to work to qualify. An "**office**" is any position which has an existence independent of the person who holds it and is capable of being filled by successive holders. Case law indicates that the position should be permanent and substantive.

- c The company must be a trading company or the holding company of a trading group

A "**trading company**" means a company carrying on trading activities whose activities do not include (to a substantial extent) non-trading activities.

HMRC have issued guidance (at CG64090) which suggests a company is a trading company if no more than 20% of turnover is from investments, no more than 20% of assets on the balance sheet are non-trading assets and no more than 20% of management time is spent on non-trading activities. HMRC apply the guidance "in the round" so, for example, they will usually accept the test is satisfied where cash exceeds 20% of assets on the balance sheet if the cash is necessary working capital. It is also possible to add goodwill and intangible assets not shown on the balance sheet to expand the denominator for the purposes of the guidance. We also understand (despite what a strict reading of the guidance would suggest) HMRC are prepared to accept a company is a trading company where it has cash in excess of necessary working capital if it has been generated from trading activities.

A "**trading group**" means a group of companies in which one or more members carry on trading activities and the members' activities, when taken together, do not include (to a substantial extent) non-trading activities.

"**Trading activities**" include not just activities carried on by a company in the course of its trade but in preparing to carry on a trade or with a view to starting or acquiring one or where it proposes to acquire a trading company or the holding company of a trading group in circumstances where it will become a subsidiary.

It is possible to apply to the HMRC Clearances Team to request confirmation in advance of a disposal as to whether a company meets the trading company tests.

Special Rules of EMI

Special rules apply to shares acquired pursuant to Enterprise Management Incentive ("**EMI**") options. The two year ER holding period runs from the grant of the EMI option and the personal company test does not apply. The relaxation of the ER rules as they apply to EMI options makes these very attractive. A separate fact sheet is available on EMI (see below).

Special Rules for External Investments Causing Dilution

The Financial Bill 2019 introduced changes to the ER Rules intended to stop the discouragement of new investment.

The new rules apply after 5 April 2019 where (broadly) an issue of shares for cash causes an individual to be diluted to below the 5% personal company threshold. The individual will be able to elect to trigger a gain which is crystallized when the investment occurs and separately to elect to defer the gain until the ultimate sale of the shares.

The elections will allow the individual to benefit from ER when it would otherwise have been lost. The individual must satisfy all the ER conditions when the investment is made and (with the exception of the personal company test) on disposal.

The election to crystallize the gain must be made on or before the first anniversary of the 31 January following the tax year in which the investment is made and the election to defer the gain must be made within 4 years of the tax year in which the investment is made. Both elections are irrevocable and advice should be taken as to when to make them.

Claiming ER

ER must be claimed on or before the first anniversary of 31 January following the tax year of disposal. If an individual disposes of shares in 2020/21, for example, he or she must claim the relief by 31 January 2023. It makes more sense for cash flow reasons; however, to claim ER when the tax is due so tax need only be paid at the 10% rate.

Application to all Securities

Once an individual satisfies the ER conditions, ER can be claimed on the disposal of any securities or interests in securities in the same company. It would be possible, for example, for an employee who qualifies for ER (because he or she has held sufficient shares for the relevant holding period) to redeem loan notes issued by the same company and claim ER on the redemption.

ER also applies to disposals made within three years after a company ceases trading if the conditions were met in the two years prior to cessation.

Anti-Avoidance Measures

ER was introduced in 2008 with a lifetime limit of £1 million which was increased over time to £10 million. By 2015, however, ER had become controversial and it has since been made progressively less attractive.

In the first Budget of 2015 the Government blocked a loophole known as a "**Manco structure**" in which joint venture companies with no trade were allowed to qualify if they held between 10% and 50% of the ordinary share capital of a trading company or the holding company of a trading group (which was at least 75% owned by five or fewer people). Since 18th March 2015, companies must (broadly) be trading companies or holding companies of a trading group in their own right to qualify.

In the Budget of 2018 the so called "**personal company test**" was made tougher to satisfy. The test is anomalous as it does not apply to sales of businesses and partnership interests. Prior to 29 October 2018 it was common to structure holdings with less than 5% economic interests using special share classes with relatively high nominal values and weighted voting rights so as to satisfy the personal company test. This was blocked by introducing an "economic" test.

For disposals on or after 29 October 2018, in addition to 5% of voting rights and 5% of ordinary share capital, the personal company test requires the individual to satisfy one of two additional economic tests. Either (a) the individual must be entitled to at least 5% of the sale proceeds on a hypothetical disposal of all the ordinary share capital, or (b) to at least 5% of profits available for distribution to all equity holders and 5% of

net assets available to equity holders on a winding-up. The 5% hypothetical test is applied on the day of sale and is (broadly) treated as met for the prior two years.

In a simple case where a company has one class of ordinary shares it is clear that a 5% holding of ordinary shares would allow the holder to satisfy all the personal company tests. If there is more than one class of shares in issue, however, the tests need careful analysis. Generally speaking, in relation to the two economic tests, the 5% hypothetical sale test is easier to satisfy as it is tested only on the date of sale and only in relation to ordinary share capital.

The alternative economic test (of 5% of distributable profits available to equity holders and 5% of assets available to equity holders on a winding-up) has to be met for every day of the relevant 1 or 2 year period prior to disposal and the definition of equity holders is complicated. It is wider than ordinary share capital because the holders of convertible debt or convertible preference shares can be treated as equity holders. The definition causes difficulties for venture backed companies and means founders with a more than 5% economic interest may not meet the test if the debt and preference shares are treated as equity shares.

The 5% hypothetical sale test was introduced after consultation to allow founders with a more than 5% economic interest still to qualify for ER. This test is simpler to meet and is likely to be relied on more in practice.

The lifetime limit was reduced in the Budget of 2020 from £10 million back to £1 million for disposals on or after 11 March 2020. The changes were controversial as they included retrospective anti-forestalling measures. For disposals between 5 April 2019 and 11 March 2020, the £1 million limit applies to non-commercial disposals and to disposals to certain connected companies entered into in order to crystalize the relief.

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Chambers UK, 2018

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Other Fact Sheets Available:

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[Company Share Option Plans](#)

[Discretionary Share Option Plans](#)

[Employee Share Markets](#)

[Enterprise Management Incentive Plans](#)

[Long Term Incentive Plans and Deferred Bonus Plans](#)

[Share Incentive Plans](#)

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