



Capital Gains Tax Qualifying for Entrepreneur's Relief on Sales of Businesses

Important changes to the capital gains tax rules relating to sales of businesses by individuals were introduced from 6 April 2008. Although the previous rules relating to "taper relief" were complex, it was possible for many people selling businesses or shares in trading companies or even certain commercial properties to qualify for an effective 10% capital gains tax rate on an unlimited amount of gains.

From 6 April 2008, the rate of capital gains tax was reduced to 18% on gains on all types of assets subject to any other reliefs available.

The newly introduced "Entrepreneur's Relief" reduces the rate on certain taxable gains for the first £1m of gain claimed during an individual's lifetime. This is done by way of a discount and the effect of the discount is broadly to reduce the rate of capital gains tax to 10%, but subject to the £1m cap.

As always with tax reliefs it is important to be sure that the precise conditions of the relief are met. Points to watch out for in Entrepreneur's Relief include:

- Sole traders or partners must sell the whole or a viable part of the business to qualify for the relief. Selling an individual business asset will not qualify unless this happens after the business has actually ceased, and within three years of that cessation.
- Sole traders and partners must have carried on the business for at least 12 months prior to the date of sale or up to the date of cessation of trading.
- Entrepreneur's Relief will only be available on sales of shares where those are shares in a trading company or the holding company of a trading group. Any significant assets or activities within the company or group which are of a non-trading nature (for example the holding of an investment property) could cause problems in this regard and a careful review will be required. Sometimes very large amounts of cash held by a company which significantly exceed business requirements might be regarded by HM Revenue & Customs as a cash investment for this purpose.
- Where a sale of shares is concerned, the company must also be the shareholders' "personal" company. This means that they must have at least 5% of the ordinary share capital of the company, 5% of the voting rights in the company and be an officer or employee of the company and they must satisfy those tests for at least 12 months

prior to the disposal of the shares. In a family company some shareholders may not be employees or small shareholdings may be held below the 5% requirement

- If a gain arises on shares in a trading company because it is wound-up after it has ceased trading, then the personal company conditions will have to be met in the 12 months up to the date that trading ceased and the winding up will have to take place within three years of the cessation of trading.

In these circumstances, planning ahead of any sale of a company may be important to try and ensure that these requirements can be met in the crucial 12 month period prior to sale.

Two other areas require special attention with regard to the availability of Entrepreneur's Relief.

Associated Disposals of Property etc

It is very common for directors of limited companies or members of partnerships to own certain assets (usually a building) in their own name, but make it available for the use of their company or partnership, sometimes charging a rent for this and sometimes not. Entrepreneur's Relief is only available on a gain made on the sale of such assets where the sale is associated with a withdrawal of the individual from the partnership or a sale of their company shares.

Furthermore the relief is restricted if a rent has been charged since 6 April this year for the use of the property. If a full commercial rent has been charged for the whole period between 6 April 2008 and the date of disposal there will be no relief due for this period. In cases where a full commercial rent has not been charged for some or all of the period post 5 April 2008, a proportionate amount of relief will be due.

Individuals who own property in this way and are now changing their partnership or limited company a rent for the use of it, may therefore have to consider whether they should stop doing so in order to protect the availability of Entrepreneur's Relief on a subsequent sale of the property in the circumstances outlined above. The answer will not always be clear depending upon the likelihood of any future sale of the business in association with the sale of the property and whether the tax saving by obtaining Entrepreneur's Relief will be sufficient to justify losing the national insurance contribution advantage and corporation tax deduction from charging rents in this way on a yearly basis.

Additionally, any loan interest which had hitherto been deductible against the rental income would then cease to qualify for tax relief.

Sales of Companies Partly for Loan Notes

It is not uncommon for part of the consideration for the sale of shares in a company to be in the form of loan notes which can be redeemed at some future date. Normally the capital gains liability on this part of the consideration doesn't arise until the date of redemption so the question arises as to whether Entrepreneur's Relief would be available at that point. The issue is highly technical and involves complex tax legislation. In particular it will depend upon whether the loan notes are in the form of "Qualifying Corporate Bonds" (QCB) or "non-Qualifying Corporate Bonds" (non-QCB).

Non-QCB can usually be identified because they will give the holder a right to redeem the notes in a foreign currency, but expert opinion should always be sought when reviewing what the correct classification of the loan note is.

Broadly where the loan notes are QCB their redemption after 5 April 2008 should qualify for Entrepreneur's Relief subject to the lifetime limit and subject to the original sale of the shares meeting the Entrepreneur's Relief conditions (even if the sale took place prior to 6 April 2008).

Redemption of non-QCB will only qualify for Entrepreneur's Relief if in the 12 months up to the date of redemption the "personal company" conditions described above are met in respect of the company which has issued the loan notes. In practice it will often be difficult to meet these conditions so where Entrepreneur's Relief is important careful thought needs to be given to the type of loan note which will be used.

As indicated at the outset, these changes apply to individuals, although Entrepreneur's Relief may be available in rather limited circumstances to certain trustees. Companies can never qualify for Entrepreneur's Relief and any gain realized by a company is subject to corporation tax which is calculated as before (broadly on the proceeds received less cost or March 1982 value plus indexation).

Summary

The conclusion to be drawn from all these changes to the taxation of gains on individuals is that no one should assume that the Entrepreneur's Relief is going to be available on the sale of a business or shares. As clearly demonstrated above, there are a number of very important qualifying conditions and in certain circumstances (and certainly without advance planning) it is perfectly possible that these conditions will not be met in a number of cases.

If you have any concerns or queries, do call Sue Stephens in our tax department.