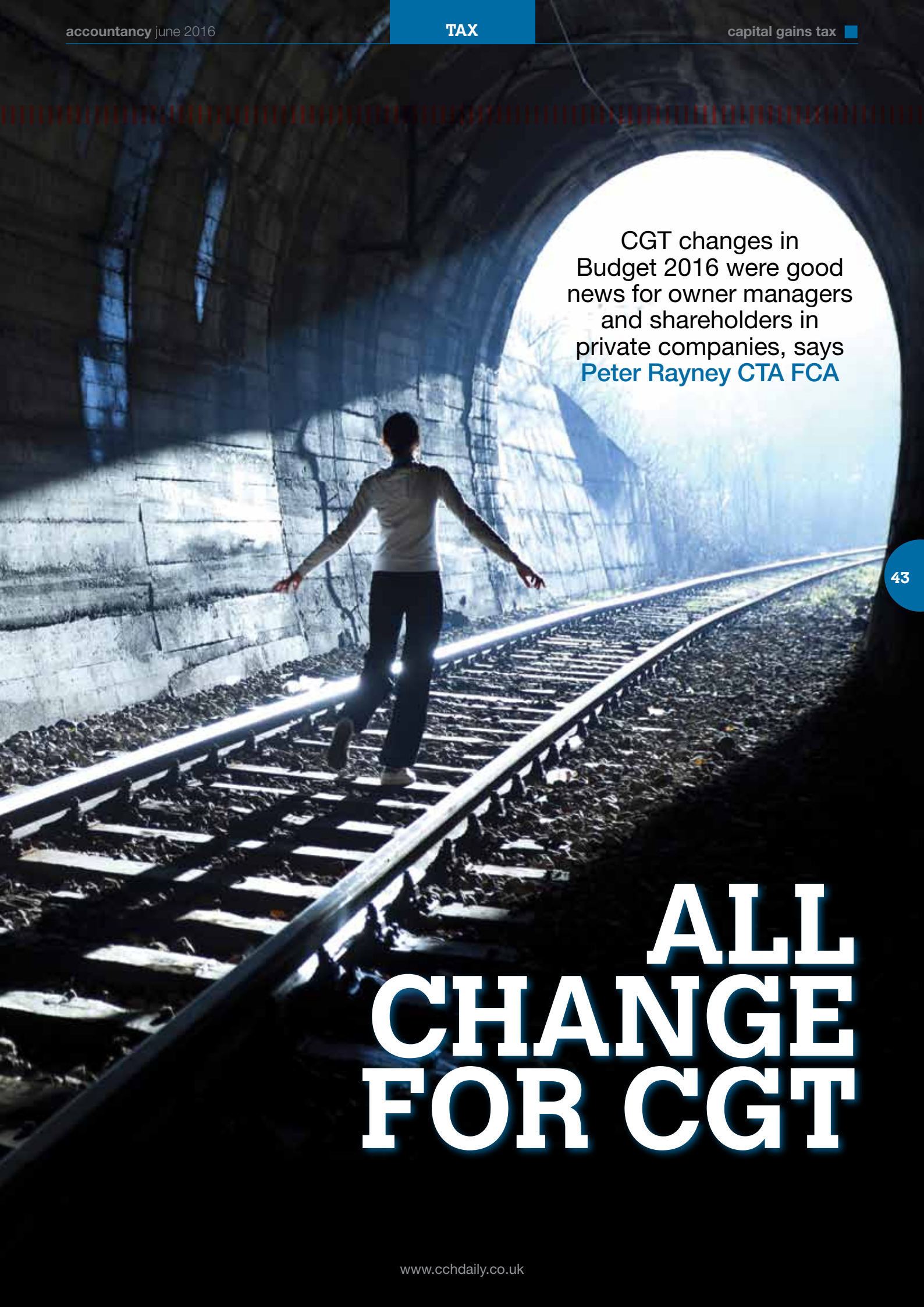


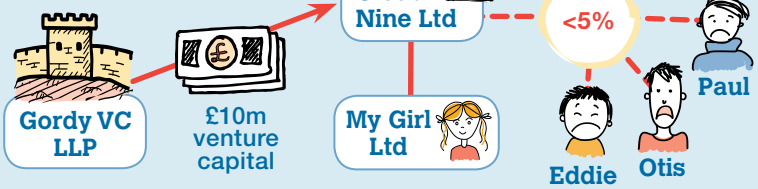
CGT changes in Budget 2016 were good news for owner managers and shareholders in private companies, says Peter Rayney CTA FCA

ALL CHANGE FOR CGT

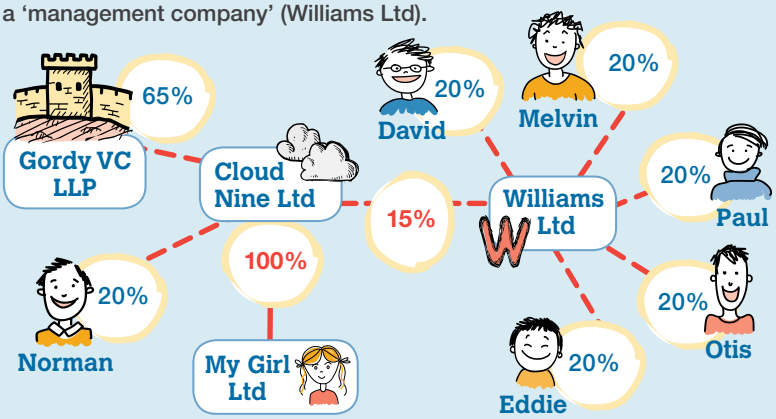
EXAMPLE 1

HOW THE JV RULES WERE ABUSED

In 2012, My Girl Ltd (a trading company) was subject to a secondary buyout, with £10m venture capital finance being secured from Gordy VC LLP. It was not possible to issue all the members of the senior management team (David, Melvin, Paul, Otis and Eddie) at least 5% of the voting equity in the new holding company, Cloud Nine Ltd.



However, under the original JV rules, it was possible for the senior management to qualify for ER by structuring their shareholdings through a 'management company' (Williams Ltd).



Before FA 2015, this structure enabled:

- Cloud Nine Ltd (the JV company) and My Girl Ltd to be treated as carrying on a single trade;
- 15% of these trading activities to be attributed to Williams Ltd; and
- each member of the management team (holding more than 5% of the ordinary 'voting' share capital of Williams Ltd) to qualify for ER on a disposal of their shares.

The Budget 2016 in March introduced some significant capital gains tax (CGT) breaks for owner managers and shareholders of private companies. Before the Budget, some had feared the 10% CGT entrepreneurs' relief (ER) might be restricted or withdrawn.

Yet the Chancellor delivered a firm indication that the 10% ER CGT rate remains a cornerstone for owner managers' taxation. Furthermore, the 10% CGT rate was also extended to long-term investors in unlisted trading companies under a new style 'investors relief' (IR). However, the 'surprise' Budget rabbit was the reduction in the headline CGT rate to 20% (previously 28%). A 28% CGT rate remains for disposals of residential property but this is not considered further here.

A 20% CGT rate is relatively palatable and should benefit business owners and shareholders who are unable to enjoy ER – for example, because they hold less than the required 5% equity stake or 'their' company is an investment company.

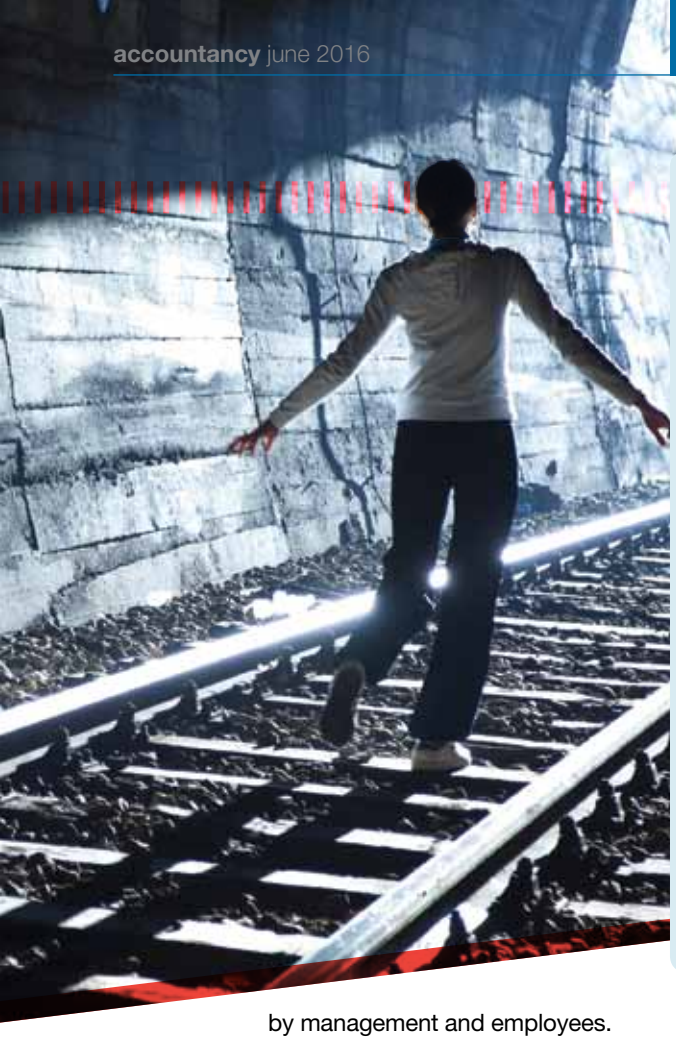
This article reviews the key CGT changes introduced by the Budget 2016 as they affect owner managers and other shareholders of owner managed companies.

ENTREPRENEURS' RELIEF

ER is probably the most valuable tax break available to owner managers, although the 'value' of the relief has now reduced with the 'default' CGT rate decreasing to 20% ER. It enables them to sell 'their' business or company at a modest 10% CGT rate on gains of up to a lifetime limit of £10m. However, the benefits of ER can be eroded by a lack of diligent planning.

Most companies will easily meet the ER requirement to be a 'qualifying trading company or holding company of a trading group' within the one year prior to the share disposal. However, some profitable companies seek to invest their surplus funds in property or other types of investment. If substantial amounts are directed towards investment activity, the relevant company may fail the (relatively stringent) ER 'trading' requirement in section 165A, Taxation of Chargeable Gains Act 1992 (TCGA 1992).

For ER purposes, the relevant company/group must be entirely trading subject to an important de minimis rule that enables 'non-substantial' investment activities to be ignored (s165A (3), TCGA 1992). The assessment of a company's ER trading status can be a subjective exercise. HMRC has indicated that it would apply a '20% test' when assessing whether the investment activities were substantial. This 20% benchmark would be applied across a range of measures, including turnover, the asset-base, expenses, and time spent

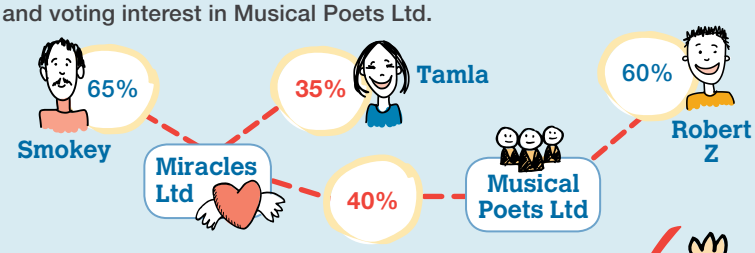


EXAMPLE 2

THE NEW JV ATTRIBUTION RULES

Assume Miracles Ltd and its 40% holding in Musical Poets Ltd are worth £1m and £50m respectively. This may cause HMRC to consider that (initially) Miracles Ltd is not a qualifying trading company for ER purposes.

Assume Tamla were to sell her 35% shareholding in Miracles Ltd. To make a robust ER claim, Tamla could put Miracles Ltd's trading status beyond any doubt by applying the JV rules. However, she could only use these rules if she had a 5% or more 'effective' shareholding and voting interest in Musical Poets Ltd.



Under the statutory formula, she would have an effective 14% shareholding/voting interest in Musical Poets Ltd (ie, 35% x 40%) and can therefore make a competent ER claim.

by management and employees.

Thus, for example, the turnover/sales income from non-trading activities would be compared with the total turnover generated by the company and so on. It may be necessary to build up the correct picture over time and this may involve striking a balance between all these factors (Inland Revenue [now HMRC] *Tax Bulletin*, Issue 62, Dec 2002).

There is also a view that the profit and loss account provides a better measure of 'activity' than a balance sheet, and therefore more weight should be given to a company's turnover, income, costs, and management/employee time.

PROBLEMS WITH JOINT VENTURES

Many companies enter into commercially structured joint venture (JV) arrangements, which may involve them having less than a 'controlling interest' in the JV company. Under general principles, these JV interests would be regarded as investments and, depending on the amounts involved, could prejudice a company's/group's 'trading' status for ER.

However, the legislation originally offered a relaxation for interests in JV companies, which normally enabled them to be treated as part of a company's trade. Therefore, holdings of 10% or more in qualifying JV companies (ie, those in which no more than five persons held 75% or more of its ordinary share capital) were effectively treated as 'transparent' for the purposes of the ER 'trading company/trading group' test.

This meant that the relevant (shareholding percentage) share of the JV's (trading) activities could be attributed to the investing company/group. The actual holding of the shares in the JV company was disregarded.

A company's activities as a member of a partnership will be treated as 'trading' provided the individual (P) satisfies two 5% tests

Unfortunately, HMRC was concerned that these rules were being manipulated to provide ER in cases where senior management were unable to obtain the required 5% shareholding (and voting) interest – as shown in example 1.

Consequently, the Finance Act 2015 (FA 2015) abolished the favourable treatment of JV's by effectively treating the holding in a JV as an investment. This meant that the shareholders of Williams Ltd (in example 1) ceased to qualify for ER. The trade carried on by the Cloud Nine Ltd group could not be attributed to Williams Ltd and its 15% shareholding in Cloud Nine Ltd became an investment.

However, this arbitrary change prejudiced the ER treatment for shareholders holding shares in companies and groups that had commercial JV interests. The government acknowledges that the FA 2015 changes went further than intended. Consequently, the Budget 2016 reinstates the former JV attribution rules but in a much more 'targeted' manner.

The new JV attribution rules will now only apply where the shareholders claiming ER have held at least an effective 5% (shareholding and voting) interest in the underlying JV company throughout the relevant 12-month ER qualifying period. This change is backdated to share disposals made after 17 March 2015.

The calculation of the effective 5% shareholding and voting interests are laid down in paras 5 to 12, (new) Sch 13, TCGA 1992. Broadly, an individual's shareholding interest in the investing company (IC) is found by adding their direct and indirect shareholdings in the JV company. The voting rights test is calculated in the same way.

The indirect shareholding is found by the following formula:

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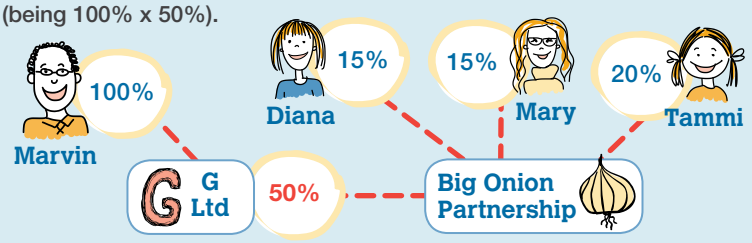
EXAMPLE 3

ER TREATMENT OF SHARES HELD THROUGH A CORPORATE PARTNER

Percentages reflect entitlement to partnership profits, assets and voting rights. Marvin's effective interest in Big Onion Partnership is 50% (being 100% x 50%).



Thus, on any future 'disposal' of his 100% shareholding in G Ltd, he should be able to treat G Ltd as a trading company for ER (it would be deemed to carry on 50% of the partnership's trading activities).

R x S x 100, where
R = shareholder's fraction of IC's ordinary share capital/voting rights (as appropriate)
S = IC's fractional direct/indirect interest in the JV

Note: when 'tracing' through a group, all 51% plus group shareholdings are deemed to be 100%.

These rules should assist companies/groups establishing their 'trading' status for ER purposes where they have commercial JV interests (see example 2). By contrast, this does not assist the management shareholders in the (arguably) artificial corporate structure in example 1, since they would only have an effective shareholding/voting interest of 3% (ie, 20% x 15%).

ER TREATMENT OF CORPORATE PARTNERS

Historically, where a company held an interest in a partnership, this was treated as 'transparent' for the purposes of determining the 'trading' status for ER purposes. As with joint ventures, the FA 2015 sought to counter abuse in this area by providing that partnership interests would be treated as a 'non-trading' activity of the corporate partner for ER purposes. However, this capricious amendment affected many commercial structures that included corporate partners.

The Budget 2016 now provides a welcome relaxation of the 'deemed non-trading' activity rule for partnerships (backdated to 18 March 2015). A company's activities as a member of a partnership will be treated as 'trading' provided the individual (P) satisfies two 5% tests in relation to the partnership throughout the relevant 12-month qualifying ER period.

This means that P must be effectively entitled to at least 5% of:

- the underlying partnership's profits and assets; and
- the partnership voting rights.

The calculation of P's effective interest in the partnership covers their direct interest in the partnership, indirect interests held by the relevant corporate partner and other direct interest companies. Example 3 illustrates the operation of these rules for a simple corporate partner structure.Limited liability partnerships (LLPs) are treated in the same way as partnerships for these purposes.

Shareholders who are not employees or directors of the investee company can benefit from investors' relief for long-term investors

NEW INVESTORS' RELIEF (IR)

Shareholders who are not employed by, or are not directors of the investee company, can benefit from a new form of relief for long-term investors – known as 'investors relief' (IR), which seems to be a hybrid of ER and the Enterprise Investment Scheme (EIS) relief, as it contains features from both these regimes.

IR enables gains on disposals to be taxed at 10% (new s169VA (1)(2), TCGA 1992). This is a 'capital gains' only relief (there is no 'upfront' income tax relief). The 10% IR CGT rate is only available after the shares have been held for at least three years (example 4).

The detailed qualifying conditions are:

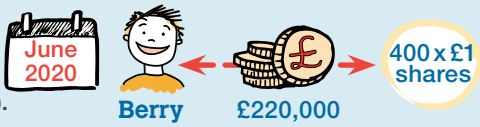
- the 'investor' must have subscribed for ordinary shares (after 16 March 2016) in an unlisted company. IR relief is not therefore available for shares purchased 'second-hand'. However, in contrast to ER, there is no minimum shareholding requirement.
- the shares must be fully paid-up in cash and issued on arm's length terms, Furthermore, the share issue must be made for genuine commercial reasons (and not mainly for a tax avoidance purpose).
- the investor must hold the relevant ordinary shares for at least three years (this is known as the 'share-holding' period). The three-year

EXAMPLE 4

INVESTORS RELIEF ON SALE OF SHARES (AFTER THIRD ANNIVERSARY OF SUBSCRIPTION

Berry subscribed for 400 of the 1,000 £1 ordinary shares at par that were issued on the incorporation of Hitsville UK Ltd on 31 March 2016. Hitsville UK Ltd operates as a musical productions and promotions company.

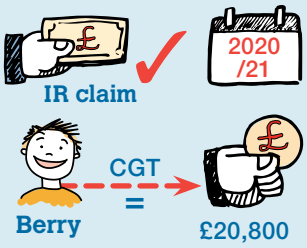
Assume Berry sells his 400 shares in the company in (say) June 2020 for £220,000 (net of legal costs).



Hitsville UK Ltd remained IR-compliant in the three years to 6 April 2019 and Berry did not work for the company during this period.

Berry's CGT liability in 2020/21 (with an IR claim) would be £20,800, which is calculated as follows:

Sale proceeds	£220,000
Less: Cost	£(400)
Gain	£219,600
Less: Annual exemption (say)	£(11,600)
Taxable gain	£208,000
@ 10% IR CGT rate	£20,800



share-holding period cannot begin until 6 April 2016 at the earliest. The IR legislation contains special rules to 'look-through' any share exchange or company reorganisation for the purposes of applying the three-year 'holding' test.

- the investor must not be employed or hold a directorship with the investee company or any 'related' company at any time in 'three-year' share-holding period. However, there are no other 'connection' conditions, so it would be possible, for example, for the investor to hold more than 30% of the issued share capital/ voting rights.
- the investee company must qualify as a trading company or holding company of a trading group throughout the 'three-year' share-holding period. These definitions adopt the 'trading' tests used in s165A, TCGA 1992 (which are the same as those used for ER and gift of business assets hold-over relief).

A claim can be made to tax gains on IR-eligible shares (net of any allowable capital losses) at the 10% IR CGT rate (see example 4). Where the investor disposes of a 'mixed' holding of IR-eligible shares and non-IR shares, the gain eligible for IR is calculated on a pro-rata basis. Thus, the qualifying IR gain is determined by applying the fraction Q/T, where:

Q = total number of 'IR-eligible' shares included in the disposal; and
T = total number of all shares comprised in the disposal.

An investor's IR claims are subject to an overriding lifetime gains limit of £10m (which is separate from the lifetime ER £10m limit). IR relief is denied where the investor 'receives value' from the investee company (other than insignificant value).

The IR 'value received' rules are modelled on the ones used for the EIS (see new Sch 7ZB, TCGA 1992). In practice, this means any dividends paid out to the investor must not exceed a 'normal return' on an equity investment in the company and interest on any loans made by the investor to the company cannot exceed a 'reasonable commercial return'.

The impact of the new CGT regime clearly has immediate implications, which need to be factored into everyday tax planning and thinking. For example, in the light of the new 20% CGT rate, some advisers might rethink their incorporation planning. Whilst sole traders and partners cannot claim ER on goodwill sold to the company, paying a 20% CGT rate may now be an acceptable cost for crediting goodwill to a director's loan account on incorporation.

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