

Entrepreneurs Relief from CGT: changes to the 'personal company' tests on share sales

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The context

When individual employees or directors sell shares in a trading company, or a holding company of a trading group, they may be able to claim entrepreneurs relief ('ER') from CGT on the sale of their shares in that company. For higher rate tax payers ER can reduce the rate of CGT from 20% to 10%, subject to a cap of £10m of life-time chargeable gains.

In order to qualify for ER on a share disposal, it needs to be a sale of shares in the 'personal company' of the selling shareholder. Without going into all the details of that definition and the other ER qualifying conditions, up until 29 October 2018 that meant the selling employee or director would need to have held at least 5% of:

- the ordinary share capital of the company; and
- the voting rights in that company (by virtue of that shareholding),

for at least 12 months up until the date of disposal of the shares.

The October 2018 change

With effect from 29 October 2018 two new tests were added which had to be satisfied in order for a company to be treated as the 'personal company' of the selling shareholder for ER purposes, namely that:

- the individual seller is beneficially entitled to at least 5% of the profits available for distribution to equity holders of the company; and
- on a winding up, the individual would be beneficially entitled to at least 5% of the assets available for distribution to equity holders of the company.

This caused some concern amongst advisers in terms of how these new tests might apply and be interpreted in the context of a sale of shares in a private limited company. These two new tests are similar to some tests in other parts of tax legislation, but it could be difficult for a shareholder to confirm definitely that they satisfy them in certain situations. So for example where a company's articles state that one or more classes of share have some discretionary rights to dividends, that could make it difficult to be certain that a shareholder has at least 5% beneficial entitlement to distributions, and so whether they might qualify for ER on a share sale under these tests.

The December 2018 changes

Concerns were raised with HMRC, including from professional bodies, as to how these October 2018 tests would work in practice. Just before Christmas, in what may have been a rare sign of festive goodwill to tax payers, HMRC announced what is in effect a relaxation of the October 2018 new tests (in relation to personal companies for ER purposes) albeit by adding another alternative test. So the current working draft of the Finance Bill says on this point that the selling shareholder can in effect either:

- satisfy the two October tests (as set out above); or

- satisfy the new test announced just before Christmas 2018, namely: **'in the event of a disposal of the whole of the ordinary share capital of the company, the individual would be beneficially entitled to at least 5% of the proceeds'** [schedule 16, paragraph 2(4), Finance (No. 3) Bill 2017-2019]

This is a welcome relaxation, and may make it easier for some selling shareholders to decide whether they satisfy the ER tests for the requisite shareholdings in a 'personal company'. The 'personal company' tests, including the alternative new test set out above, would need to be satisfied for at least the 12 months up to date of disposal of the shares, as has been the case with the 'personal company' tests generally so far (but see the comments below under 'A question of timing').

Please note that a selling shareholder would still need to satisfy the other parts of the 'personal company' ER tests which have been in place for a few years, as referred to earlier in this note, namely holding 5% of the ordinary share capital and of the voting rights.

NB: as many readers of this note will be aware, the 5% thresholds for the 'personal company' tests can be relaxed in relation to shares acquired under qualifying Enterprise Management Incentive share options, but the details of that are beyond the scope of this update.

A question of timing

In the autumn 2018 Budget, there was a further significant change pre-announced in relation to the ER tests for selling shareholders: the period in which the ER tests need to be satisfied up to the time of disposal of the shares. This period is going to be extended from 12 months to 24 months, for disposals taking place after 5 April 2019.

Where the shares are being sold in a company which has been incorporated for less than 24 months, it may still be possible for a selling shareholder to fall within the time periods for ER qualification (assuming all the other ER statutory conditions are satisfied). Broadly speaking, this may be the case where the selling shareholder received shares in the company to be sold, in consideration of transferring an unincorporated business into the company. There are detailed conditions which should be carefully checked as to when this relaxation may be available.

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