

Entrepreneurs' Relief Amendments in UK Finance Bill 2019

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Important changes to the conditions for entrepreneurs' relief are proposed in the UK's Finance Bill 2019.

Entrepreneurs' relief, a capital gains tax relief designed to support business investment and growth of new enterprises, allows certain individuals disposing of shares or securities in their employer to pay a reduced rate of capital gains tax. Provided the relevant conditions are satisfied, qualifying gains are subject to a reduced capital gains tax rate of 10%, rather than the standard rate of 20%.

Two significant changes to the conditions for entrepreneurs' relief were announced at the UK Autumn Budget, with draft legislation published in Finance Bill 2019:

- from 29 October 2018, further conditions need to be met for shareholdings to qualify for entrepreneurs' relief; and
- from 6 April 2019, the "holding period", during which the conditions for entrepreneurs' relief must be met, will be extended from one year to two years.

The amendments seek to ensure that the relief is targeted at those with a material economic stake in the business; the explanatory notes published with Finance Bill 2019 state that the government considers longer-term involvement and entitlement to share in the profits and assets of a company to be more characteristic of entrepreneurial activity.

Qualifying Conditions

Broadly speaking, in order to qualify for entrepreneurs' relief on a disposal of shares or securities in a company, an individual must hold at least 5% of the issued ordinary share capital of the company, allowing the individual to exercise at least 5% of the company's voting rights. For disposals from 29 October 2018, the Finance Bill changes will (if enacted in their current form) require that the individual is also beneficially entitled to either:

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- 5% of the distributable profits available for distribution to equity holders and 5% of the assets available for distribution to equity holders on a winding-up. “Equity holders” includes holders of certain financial instruments (other than normal commercial loans) as well as shareholders (other than those holding restricted preference shares); or
- 5% of the proceeds in the event of a disposal of the whole of the company’s ordinary share capital.

The second alternative above was introduced as a helpful amendment after the Finance Bill 2019 was originally published, to address the circumstance where an individual cannot demonstrate their entitlement to profits and assets but can demonstrate a sufficient economic stake through their entitlement to sale proceeds.

For the purposes of establishing whether the 5% of proceeds in the event of a disposal test is met at any point in a period, the effect of any avoidance arrangements is disregarded, and it is assumed that:

- the whole of the ordinary share capital of the company is sold for a consideration equal to its market value on the final day of the period; and
- the individual’s share of the proceeds is the amount that it is reasonable to expect they would have been beneficially entitled to in the circumstances in place at the time.

Further conditions for entrepreneurs’ relief include that the company is a trading company (or the holding company of a trading group) and that the individual is an officer or employee of the company or a company within its trading group.

Holding Period

The conditions must be met throughout a holding period, ending with the date of disposal. Currently, the conditions need to be met for a one year period; under the proposed changes, the holding period will be increased to two years from 6 April 2019.

EMI Share Options

The requirements for an individual to hold 5% of ordinary share capital and voting rights as well as either 5% of distributable profits and assets on a winding-up or 5% of proceeds on a disposal do not apply to shares which are acquired upon exercise of Enterprise Management Incentive (EMI) share options. Disposals of shares acquired on the exercise of EMI options can qualify for entrepreneurs’ relief regardless of the 5% tests, provided the other conditions are met. EMI option plans may become more popular as a result of the proposed additions to the 5% tests for non-EMI shares.

The holding period during which the conditions must be met will, as for non-EMI shares, be increased from one year to two for disposals from 6 April 2019. For EMI share options, the holding period runs from the date on which the option is acquired by the employee, rather than the date on which the shares themselves are acquired.

Further Changes: Dilution of Holdings

A helpful development if Finance Bill 2019 is enacted in its current form will extend entrepreneurs’ relief so that individuals whose shareholding is reduced below 5% as a result of raising equity finance can claim the relief in part if they dispose of their securities after such dilution. Entrepreneurs’ relief will be available on the part of the gain that arose before the dilution,

but not on the gain arising between dilution and disposal.

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