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Proposed Changes to Entrepreneurs' Relief

In the UK Government's Fall 2018 budget (Budget), recent changes were announced to Entrepreneurs' Relief to ensure that relief is available only to "genuine entrepreneurs". Entrepreneurs' Relief reduces the rate of capital gains tax to 10 percent on the first £10 million of gains made on disposals of "qualifying assets", broadly, businesses, Enterprise Management Incentives (EMI) shares or shares in a "personal company". The pre-Budget 5 percent holding requirement for shares in personal companies (5 percent of ordinary shares by nominal value and 5 percent of voting rights) has been extended to include a 5 percent "economic test" with effect from 28 October 2018. In addition, the period for which shareholders must hold shares before being eligible for the Entrepreneurs' Relief is proposed to be extended from one year to two years, as explained below.

The Economic Test

To be eligible for Entrepreneurs' Relief, shareholders now additionally have to be entitled to:

- 5 percent of the company's profits distributable to equity holders; and
- 5 percent of the company's assets available for distribution to equity holders on a winding up.

"Equity holders" is widely defined and includes lenders who have advanced debt that is not "a normal commercial loan" (so holders of convertible debt will be "equity holders" for these purposes) and any class of shareholders other than holders of "fixed rate preference shares".

"Fixed rate preference shares" are very narrowly defined: in particular, to fall within the definition, they must not carry a dividend other than one which is of a fixed amount or at a fixed percentage of the nominal value of the shares.

These new tests are likely to result in the denial of Entrepreneurs' Relief in some private equity structures where managers have been awarded shares in a way designed to secure the relief but without a true economic interest, as there is no grandfathering of existing structures. Note, there also will be situations where shareholders do not satisfy the 5 percent economic test although they are apparently true entrepreneurs. This is because of the wide meaning of "equity holder" which can include mezzanine lenders and preference shareholders (including holders of series A or B preference shares issued in venture capital transactions) which do not satisfy the narrow definition of "fixed rate preference shares". The interests of such holders can dilute the interests of entrepreneurs in a company to less than 5 percent. For example, a founder of a venture capital-backed company who has just over 5 percent of the share capital may not be entitled to 5 percent of the distributable assets, depending on the value on the liquidity event and, as a result, the founder may not be entitled to Entrepreneurs' Relief.

For more information, please contact your Katten relationship lawyer or one of the authors.

Charlotte Sallabank
+44 (0) 20 7776 7630
charlotte.sallabank@kattenlaw.co.uk

Edward A. Tran
+44 (0) 20 7770 5254
edward.tran@kattenlaw.co.uk

The Holding Period

The second noteworthy change is that the period for which shareholders must hold shares before being eligible for Entrepreneurs' Relief is proposed to be extended from one year to two years with effect from 6 April 2019. As a result, there will be a cliff edge: a shareholder who has held shares for one year on 5 April 2019 can dispose of shares on that day and claim Entrepreneurs' Relief, whereas if the disposal occurs after 5 April 2019, a shareholder will have to hold the shares for another 12 months in order to be eligible for the relief. This rule can therefore result in an overnight doubling of the required retention period.

Subject to review of the final legislation which is expected to be available in early 2019, it is unclear as to whether entrepreneurs will be afforded any protection from the proposed changes to the conditions for the Entrepreneurs' Relief. Katten recommends that interest parties continue to monitor developments and consult with their lawyer in the coming months.

Katten

KattenMuchinRosenman UK LLP

www.kattenlaw.co.uk

Paternoster House, 65 St Paul's Churchyard • London EC4M 8AB
+44 (0) 20 7776 7620 tel • +44 (0) 20 7776 7621 fax

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