

UK Entrepreneurs' Relief Takes a Hit Following the March Budget

April 6, 2020

Entrepreneurs' relief (ER) provides for a lower rate of capital gains tax (10 percent) to be paid when disposing of all, or part, of a business, or shares or securities in a personal company, or shares from an EMI scheme, where certain criteria are met. Prior to 11 March 2020, this lower rate was subject to a lifetime limit of £10 million of qualifying gains.

ER Reduction

On 11 March 2020, the Chancellor of the Exchequer announced in the Spring Budget that the ER would be altered to reduce the lifetime limit of eligible gains from £10 million to £1 million in an effort to address the concern that ER was being used as a tax loophole rather than for legitimate entrepreneurial industry. From 11 March 2020, all disposals within the scope of ER are subject to the new lifetime limit. Although this development will not be welcomed by many entrepreneurs and other investors, it had been anticipated that the Spring Budget would include measures designed to restrict the availability of ER.

ER will be re-named '*business asset disposal relief*'; however, for the purposes of this note, Katten will continue to use the term 'ER'.

The Finance Bill 2020, published on 19 March 2020, provides the draft legislation showing how the reformed ER will operate in practice.

Forestalling Arrangements to be Limited

Beyond the changes to the figures and the name of ER, there are transitional provisions built into the legislation, aimed at catching forestalling measures.

Sale Contracts. The legislation targets forestalling arrangements designed to utilise the old lifetime limit as follows. Where an unconditional sale contract has been entered into prior to 11 March 2020 which transfers an asset on or after that date, the disposal of the asset is treated as having taken place on or after 11 March 2020 (and so the new reduced lifetime limit will apply), unless:

- the contractual parties are not connected persons and the transferor makes a statement that no purpose of entering into the contract was to crystallise a capital gains tax (CGT) disposal prior to 11 March 2020 (i.e. to enable the gain to fall within the old lifetime limit); or
- where the parties are connected persons, the sale contract was entered into wholly for commercial reasons, and the transferor makes a statement to that effect and, as for unconnected persons, that no purpose of entering into the contract was to crystallise a CGT disposal prior to the new lifetime limit applying.

Reorganisations and Share-for-Share Exchanges. Forestalling arrangements involving reorganisations of shares or share-for-share exchanges also are targeted.

- Normally, where there has been a share-for-share exchange or a reorganisation of shares, there is deemed to be no disposal for CGT purposes and the taxpayer's tax basis is rolled into the new shares. Consequently no capital gain arises on the reorganisation or share-for-share exchange. However, under the ER rules there is
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an option to crystallise the gain, meaning a charge to capital gains tax will arise at the time of the reorganisation or share-for-share exchange, in respect of which sellers can then use their ER. The option can be exercised any time before the first anniversary of the 31 January following the end of the tax year in which the share-for-share-exchange or the reorganisation took place. For example, for a share-for-share exchange that took place on 1 March 2020, the taxpayer has until 30 January 2022 in which to make the election.

- The new ER legislation does not prevent such an election being made, but if the reorganisation or share-for-share exchange was made on or after 6 April 2019, but before 11 March 2020, the date of the disposal in some situations may be deemed to be the date of the election, rather than the date of the reorganisation or share exchange. This will be the case for an election in respect of a reorganisation where:
 - the company in question was the taxpayer's personal company on 11 March 2020 (or the holding company of a trading group) and the taxpayer is an officer or employee of the company (or in the case of a trading group, of one or more of the members of the trading group) (**condition 1**); and
 - the election is made on or after 11 March 2020 (**condition 2**).

This means that the old £10 million lifetime limit will be unavailable and ER must be calculated by reference to the new lifetime limit.

- In the case of a share-for-share exchange, the test is slightly different. If either:
 - the persons who held shares in, or had control of, the company (OldCo) whose shares were exchanged for shares in another company (NewCo) immediately before the exchange are substantially the same as the shareholders of, or the persons who have control of, NewCo immediately after the exchange and condition 1 above is satisfied; or
 - the relevant shareholders in NewCo together hold a greater percentage of the shares in NewCo immediately after the exchange than they did in OldCo immediately before the exchange and conditions 1 and 2 above are satisfied, then the disposal will be deemed to have taken place on the date of the election – so the new ER limit will apply in respect of any capital gain realised on the disposal.

This election process will be of particular interest to management sellers who may have rolled their management shares in a target company into a 'bidco' or co-invest structure during this period. Where their percentage share in the bidco/co-invest structure is not greater than their share in the target entity before the buyout/co-invest, it may be advantageous for management sellers to make an election to crystallise their gain, in order to take advantage of the £10 million ER limit.

Please note that at the time this was written, this change was unaffected by the COVID-19 pandemic.

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