

# Entrepreneurs' Relief – can you still qualify?

If it is available, **Entrepreneurs' Relief can reduce the rate of capital gains tax payable on the disposal of shares to 10% (rather than the usual rate of 20%).**

**Recent changes to the conditions for Entrepreneurs' Relief mean, however, that many individual shareholders who might have expected to benefit from the relief may no longer do so.**

## What has changed?

The most significant of the changes is the introduction of two additional economic tests.

Previously, Entrepreneurs' Relief was potentially available if (during the period of one year prior to the disposal of the shares) the individual shareholder held at least 5% of the company's ordinary share capital (based upon nominal value) and could exercise at least 5% of the voting rights in the company by virtue of that shareholding.

But in respect of disposals on or after 29 October 2018, a further two economic conditions need to be satisfied. The shareholder must also be beneficially entitled to at least:

- 5% of the **profits available for distribution to equity holders** of the company; and
- 5% of the **assets available for distribution to equity holders** on a winding up of the company.

There is also a longer holding requirement – so from 6 April 2019, the conditions for Entrepreneurs' Relief must be met for **two** years, rather than one.

## What are the issues?

The two new economic tests are not straightforward to apply, and can have unexpected and unwelcome consequences.

It is **not** (as one might expect) simply a question of determining whether the shares held by the individual shareholder carry 5% or more of the equity value of the company so that, for example, on a sale of the company the individual shareholder would be entitled to receive 5% or more of the overall consideration paid.

The areas of most significant concern are as follows:

- When applying the tests you have to look at the entitlement of **equity holders** not simply shareholders – the definition includes not only all **shareholders** (unless they hold “restricted preference shares”) but **also loan creditors** (other than banks or where the loan is a “normal commercial loan”). So, for example, you also need to factor in the entitlement of holders of:
  - certain types of preference shares
  - equity linked instruments such as convertible debt
  - loans which are results dependent/limited recourse or where the return exceeds a reasonable commercial return

- The **profits available for distribution** test looks at each equity holder's **beneficial entitlement to the "total profits of the relevant accounting period"** (or, if no such profits, profits of £100) if they were to be distributed. This may cause difficulties where:
  - any other equity holder has a preferential or priority return (over and above a simple return of their initial investment)
  - shares carry no particular entitlement to a dividend, for example, where different share classes have discretionary dividend rights
- The **assets available for distribution** test looks broadly at the company's **balance sheet at the end of the relevant accounting period** to determine how much each equity holder would be beneficially entitled to if an amount equal to "the assets amount less the liabilities amount" were to be available to be distributed on a winding up. Again difficulties may arise if:
  - other investors have a liquidation preference or any other priority on a winding up
  - the company has minimal assets on the balance sheet
- The tests need to be applied by reference to relevant accounting periods – so, given that the tests need to be satisfied for two years prior to the disposal, it will usually be necessary to look at the position by reference to three accounting periods; further complications also arise if shares/securities carry rights to profits and/or assets which vary over time

### What are the consequences for you?

#### Entrepreneurs' Relief is no longer likely to be available for:

- shares where the nominal value has been manipulated and the individual never had a 5% economic entitlement
- growth shares where holders only start to participate above a hurdle amount
- shares where other investors have a liquidation preference or other priority return

#### No assumptions should be made as to the availability of Entrepreneurs' Relief where a company has:

- more than one class of shares
- any non-bank debt
- minimal assets on the balance sheet

Other than the longer holding requirement, the position for shares acquired under EMI Options is unaffected.

If you have any questions in relation to the above, or would like us to review the position to confirm whether your entitlement to Entrepreneurs' Relief has been affected, please contact Emma Bailey or Jo Varia, or your usual Fox Williams contact.



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