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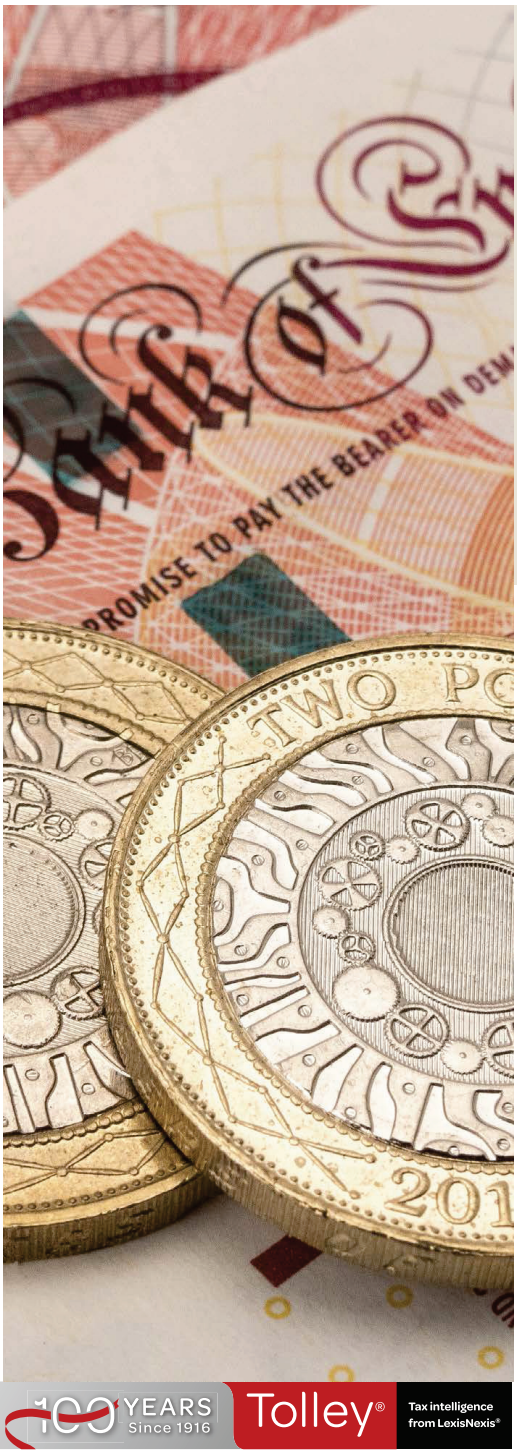

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The big read

How has entrepreneurs' relief been eroded and what opportunities remain?

Speed read

In recent years, the increasing disparity between the top rate of income tax on dividends (38.1% from 6 April 2016) and the 10% rate on capital gains qualifying for entrepreneurs' relief means that shareholders have sought opportunities to extract cash from companies as capital rather than income. Recent legislative changes, within the transactions in securities provisions and the targeted anti-avoidance rules in particular, have curbed a number of opportunities such as capital reductions, liquidations and partial exits. Despite this and an extension to investors' relief, introduced in Finance Bill 2016, entrepreneurs' relief remains an attainable and valuable relief, as long as shareholders get the basics right. Business owners can also breathe a (cautious) sigh of relief, as the government recently announced that it does not intend, for now, to introduce potentially punitive measures to deal with 'money-boxing'.

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It would be no exaggeration to say that entrepreneurs' relief (ER) has been the most valuable tax relief in recent times. When it was first introduced in 2008, it allowed a special rate of 10% on the first £1m of qualifying gains. This was increased in various stages to a lifetime allowance of £10m, effective from 6 April 2011. Given that it is relatively easy for married couples to effectively share qualifying gains, they can often enjoy £20m of gains at the low 10% rate. This capital gains tax generosity has taken place against a backdrop of generally rising income tax rates and (until recently) a relatively steady 28% higher CGT rate. There have therefore been significant (and often easy) rewards to be had, either by extracting profits as ER gains rather than income, or by ensuring that appropriate steps are taken to secure ER on a gain.

For the last five years or so, there have been many fairly simple tax planning opportunities available which take advantage of ER, although these may not have always kept within the spirit of how the rules were intended to apply. It is perhaps surprising that the government took so long to combat these opportunities, but Finance Bill 2016 certainly included a few significant moves in this direction (see 'FB 2016: Entrepreneurs' relief changes' (Martin Mann), *Tax Journal*, 22 April 2016). The aim of this article is to reflect on the extent to which some planning opportunities have been removed and to consider what still remains. It does not aim to recap in detail how the basic ER rules operate, as we anticipate that most readers will be familiar with these. However, we do recap on the main rules in very basic terms, as follows:

For one year before the CGT disposal date, the following conditions need to apply in order to meet the ER conditions on the disposal of a company:

- The company is a trading company or a holding company of a trading group.
- The shareholder is an officer or an employee of the company.
- The shareholder has at least 5% voting rights and owns at least 5% of the company's nominal share capital.

What opportunities have been curtailed?

Capital reductions

Prior to 6 April 2016, capital reductions could be a tax efficient way of extracting funds from a company. In a best case scenario, this could lead to funds being taxed at 10% rather than 30.56%. Often the share capital had not arisen through a cash subscription but on a share-for-share exchange, whereby a holding company issued an amount of share capital equivalent to the value of a company which it acquired. In this way, the share capital was 'spirited' into existence, without the shareholder having to part with any cash.

This share capital could then be reduced by the holding company receiving a distribution from its subsidiary; and then paying these funds out to its shareholder, who would claim ER in his or her tax return on the basis that the capital reduction was a capital disposal.

The main obstacle to enjoying 10% CGT treatment in these circumstances was the transactions in securities legislation (TISL), which can give HMRC the ability to ignore legal form and tax a capital reduction as a dividend, irrespective of ER status. However, the onus was always on HMRC to use this legislation (the taxpayer was unable to do so) and usually the legislation was not effective in the case of a capital reduction for a variety of technical reasons (see 'Ask an expert: Taxing a capital reduction' (Andrew Marr), *Tax Journal*, 1 October 2015). This opportunity has now been closed.

In the Autumn Statement, the following ominous statement was made:

'To reduce opportunities for income to be converted to capital to gain a tax advantage, the government will shortly publish a consultation on the company distributions rules, and will amend the transactions in securities rules and introduce a targeted anti-avoidance rule.'

Capital reductions (of the kind mentioned above) have now been brought indisputably within the TISL rules and there are few 'clever' technical arguments which can be used as a defence (for example, the specific exclusion for capital reductions which was in ITA 2007 s 685(6) has been removed). Although HMRC's mechanism for counteracting a tax advantage has been brought more in line with self-assessment processes, TISL is still not within the self-assessment regime and therefore the onus is still on HMRC to commence a dialogue on the subject. This dialogue will

now be started by HMRC raising an enquiry within six years of the end of the tax year in which the transaction takes place.

Partial exits paid for by reserves

The more subtle tweaks to the TISL in Finance Bill 2016 also mean that business owners can no longer necessarily rely on capital treatment where reserves have built up, when they undertake partial exits from their business, perhaps involving a venture capital company.

Before Finance Bill 2016 introduced amendments to the 'fundamental change in ownership' definition in the TISL, it was relatively straightforward to fall within this safe harbour and therefore outside the scope of the TISL. The 'old' definition was directed at bringing into this safe harbour any disposals of stakes of 75% or more in a close company to third parties. However, this was not how the legislation was drafted. It provided scope for the safe harbour rule to apply in cases where a new company acquired 75% or more of a close company, even if a significant stake of the new company was owned by the shareholders.

For example, take three shareholders, each with a 33.33% stake in 'Target', a company with substantial cash and reserves. A private equity investor has offered to buy a 30% stake in Target. The shareholders decide to use this opportunity to extract some reserves as capital on which they hope to benefit from ER. 'Newco' is set up to acquire 100% of Target from the shareholders, in exchange for a mixture of shares and cash consideration. The proceeds are funded via a dividend from Target, paid up to Newco tax free, after the sale. The shareholders reduce their shareholding interests to a 23.33% stake each in Newco, acquired under the share-for-share exchange provisions.

Under the 'old' TISL rules, it is possible for each shareholder to fall outside the scope of TISL as there has been a 'fundamental change in ownership' in accordance with the pre-Finance Bill 2016 version of ITA 2007 s 686. This is because Newco has acquired more than 75% of the ordinary share capital of Target. Furthermore, Newco will not be 'connected' with the original shareholders after the transaction unless a shareholder, together with 'connected persons', controls Newco.

Finance Bill 2016 replaces s 686 with a new definition, such that there is now a 'fundamental change in ownership' where 'the original shareholder or original shareholders taken together with any associate or associates' do not hold 'directly or indirectly' more than 25% of the ordinary share capital, entitlement to distributions or voting rights of the close company. In our example, the 'original shareholders taken together' will indirectly hold 70% of Target between them. Accordingly, this transaction will no longer be protected by the safe harbour. HMRC would be likely to have a good chance of counteracting any tax advantage, which could result in income tax rates of 38.1% rather than a capital gain at 10% with ER.

Liquidations

New TISL rules have also dealt a significant blow to tax advantages surrounding liquidations, bringing 'a distribution in respect of securities in a winding up' unequivocally into the definition of a 'transaction in securities'. In addition, whereas previously it was relatively easy to enjoy ER on a distribution in the course of a liquidation, a targeted anti-avoidance rule (TAAR) will now be brought within ITTOIA 2005 s 396B. This obligates a shareholder of a close company to treat the distribution as income rather than capital if within two years after the date of the distribution, the individual receiving the distribution (or someone connected with him or her) is involved in carrying on any trade or other activity previously carried on by the company (or any similar trade or activity). This can involve trading as either a company, partnership or sole trader. It is quite broadly worded legislation and has the potential to give headaches to many shareholders as they grapple with it.

For example, what happens if a shareholder liquidates his garage business in March and then buys and sells a car for a profit 23 months later? Is this enough to convert an ER capital gain into a distribution? How should the return be amended, given that it will have already been submitted and the enquiry window closed? There has been very little HMRC commentary on these kinds of issues, although it has stated that it 'would stress that it [the government] would still expect the vast majority of distributions from a winding-up to be treated as capital'.

Joint venture rules as a route to ER

Before Finance Act 2015, where a company owned shares in a 'joint venture company' (JV), special rules applied to treat the company as effectively carrying on an appropriate portion of the JV's trade. To qualify, the company had to own at least 10% of the shares and 75% of the shares had to be held by no more than five persons. These rules offered a useful way of obtaining ER for employee shareholders, where they otherwise would not have met the 5% test.

For example, Tom was setting up a new business ('Trade Ltd') and wanted to give five employees a 2% stake. If they held shares in Trade Ltd, they would not have qualified for ER. Instead, the employees could set up a shell company, 'Trade Holdings Ltd', with 20% each, which in turn would hold 10% of Trade Ltd. Applying the above rules, Trade Holdings Ltd would have qualified as a trading company and the 5% test would have been met; therefore the employees would have qualified for ER.

HMRC felt that allowing ER in these circumstances was inconsistent with the ER policy objective of giving relief to stakeholders who hold a 'substantial' interest in a business. Consequently, from 18 March 2015 the definition of a trading company for ER purposes was modified so as to exclude the JV rules (TCGA 1992 s 1695(4A)). The arrangement described above therefore no longer worked unless Trade Holdings Ltd qualified as a trading company (or holding company of a trading company) in its own right.

Can anything be salvaged?

The rule changes highlighted above are not all as negative as they seem. For example, in many cases liquidations can still be effectively used to return profits as capital. Also, there are still various opportunities to allow key management to enjoy the benefits of ER.

Revisiting partial exits

Although the fundamental change of ownership (FCOO) exemption will no longer offer protection for capital treatment in many 'Newco cases', as outlined above, all may not be lost. It is worth remembering that FCOO is a 'safe harbour' test (ITA 2007 s 684(1)(b)); and failure does not automatically mean that TISL will apply to convert capital receipts into a distribution. Given this new uncertainty, TISL clearance should always be sought for these kinds of transactions. Based on our experience of dealing with HMRC, we would expect there to be a good chance of

receiving clearance in cases where the shareholders (as a group) dispose of over 50% of their shares; however, HMRC would be unlikely to grant clearance where the original shareholders continue to have control as a group.

Some comfort can also be taken from the fact that the onus is still on HMRC to invoke TISL. Therefore, there should be little prospect of penalties in cases where a counteraction notice is successfully invoked. This may not be good enough for some shareholders, who will want a greater level of certainty about the prospect of ER on a partial exit and may not be prepared to proceed with the transaction without that assurance.

Revisiting liquidations

There may still be opportunities to take advantage of liquidations to extract funds at 10% despite the new TISL rules in Finance Bill 2016 cl 33(3), as follows:

1. Cease trading and then liquidate within three years of trade cessation. For distributions to be taxable at 10%, there would have to be a plan for the shareholders to also cease any related activities within the three year period, so that liquidation distributions can take place after the related business activities have ceased. Otherwise, the new legislation (above) would treat distributions as being taxable as dividends.
2. The new rules only apply to 'close companies', which means that it only applies to companies controlled by five or fewer participators. Although this is likely to be the case for most privately owned companies, syndicate-type companies may fall outside these rules (e.g. a property development syndicate with more than 10 members). Clearly, shareholders would need to meet other ER conditions in order to benefit from the 10% rate.
3. The new rules will not apply in any event where a shareholding is no higher than 5% (but lower than 5% would mean no ER).

> There may still be opportunities to take advantage of liquidations to extract funds at 10%, despite Finance Bill 2016

Given that the top rate of CGT has been reduced to 20% from 6 April 2016, it is also worth noting that there is an increased incentive to protect capital treatment of liquidations, even if ER is unavailable.

Given the vagueness of this new legislation (e.g. 'similar trade or activity' is not properly defined), there is likely to be a surge of non-statutory business clearance applications which seek clarifications on specific cases. Although HMRC has suggested that this legislation is only aimed at combating 'phoenixism', it is much wider than this. Hopefully, in practice, it will be possible to get HMRC to agree that this legislation will only bite in cases where a specific business carries on following a liquidation for which there was no good (non-tax) reason.

Revisiting ER and 5% requirements

By reference to the Trade Ltd example above, whilst Trade Holdings Ltd would now no longer qualify as a 'trading company', this may not matter if it satisfies the definition of a holding company. The rules here are unchanged. The company simply has to own 51% of the ordinary share capital of one or more subsidiaries. As the definition of 'ordinary share capital' is by reference to *nominal* share capital (i.e. not including share premium), one solution could be to issue Holdco with further shares with a high nominal value to 'bump' it up to the 51% threshold.

For example, in the above scenario, assume Trade Holdings Ltd originally held 10 of the 100 £1 shares issued. By issuing 10 new £10 'B' shares to Holdco, it would own shares with a nominal value of £110 out of a total share capital of £200 (55%) and therefore qualify as a holding company.

Although this should work by the letter of the legislation, as it is clearly against the grain of policy intention, it is one probably best used for existing structures which were affected by the 2015 legislation.

In any event, there are other possible solutions whereby key management can be put into an ER qualifying position. It remains relatively easy to satisfy the 5% share capital requirement through the issue of nominal share capital with a low commercial value, although the 5% voting requirement can often prove onerous in these circumstances. If the 5% voting criteria does prove problematic, then consideration could be given to a grant of EMI options. Even if these are immediately exercised by the employee, then (irrespective of voting power) any disposal which takes place at least a year after the grant can potentially benefit from ER.

Where a low value can be agreed for shares, employers may be inclined to forget about the ER position of their employees and go down the employee shareholder status route. Although these shares no longer enjoy an unlimited capital gains tax exemption (further to George Osborne's recent U-turn), there is still a lifetime £100,000 exemption. Coupled with the lower 20% tax rate, this can still make them an attractive option. This route also has a very useful pre-transaction valuation check facility.

What opportunities remain?

'Money-boxing' – on hold for now

In recent years, a 10% CGT rate under ER, compared with the top rate of tax on dividends (now at 38.1%), has become increasingly attractive. It means that business owners may be tempted to reduce their annual dividends from the company, in favour of building up reserves in anticipation of extracting these as capital (via a liquidation or sale) when the owner eventually retires, sells or partially exits. This issue is very much on HMRC's agenda (and was highlighted in its consultation document on distributions), although nothing has been specifically done to counter this issue.

It is generally accepted that surplus cash accumulated by a profitable company, and which exceeds working capital requirements (or even earmarked projects), will not generally taint the trading status of a company for ER purposes. This should be the position, unless the scale of management time devoted to managing the funds is so significant that it becomes a separate and 'substantial' non-trading activity in its own right. The fact that ER conditions can still be met with significant surplus cash has led HMRC to suggest some quite radical 'solutions' to the problem, such as taxing the profits of a company as they build up, irrespective of whether they are distributed. (Similar rules existed in the 1970s and 1980s.) This would be quite draconian but would undoubtedly erode any advantages associated with 'money-boxing'.

Another possibility mentioned in the consultation was that an allowance of distributable reserves could be introduced, which can be treated as capital in the event of a sale – with anything else being taxed as a distribution. This would have the advantage of simplicity but it would fail to

recognise the fact that companies reinvest their profits in expanding the business and cannot always simply pay out their reserves.

The results of the consultation were published in February with the news that the government appears to have been persuaded (for now) by the range of complex commercial issues that would arise in attempts to deal with money-boxing, beyond curbing opportunities for capital reductions or liquidations. It is likely that measures will be brought in to combat 'money-boxing' over the next few years. However, it currently makes good sense for shareholders who have a sale or liquidation on the cards to carefully consider their position before their companies make distributions.

The beauty of the 12 month qualifying period

One of the ongoing benefits of the ER legislation is that ER is available on a share sale if the conditions have been met in the 12 month period before sale. This contrasts favourably with the rules for business asset taper relief (BATR), which was ER's predecessor. The availability of BATR was eroded for the 'non-business use' of an asset in a ten year period up to sale. For share disposals, however, we are only interested in what was going on in the year up to disposal.

This 12 month rule facilitates fairly straightforward planning whereby the house can be got into order, as long as steps are taken over 12 months before any sale. For example, shareholders can ensure that they are not falling foul of the 'officer or employee' condition; and inter-spouse transfers can be made in order to access a spouse's ER allowance (providing, of course, that the spouse meets the various ER conditions).

Due to the leniency of this qualifying period, there also may sometimes be cases where a non-ER qualifying company can be converted into a trading company, therefore accessing ER.

By way of example, consider the following:

- A property investment company has been owned for ten years.
- There is £6m of 'gain' inherent in the shares.
- The company owns a large commercial premises, which is rented out.
- Planning permission is obtained to develop residential apartments.
- The development process takes a couple of years.
- After a sale which realises a total profit of £10m, the company is liquidated (after suffering corporation tax in respect of the sale).

Here, the shareholders should enjoy full ER (assuming that other ER conditions are met). HMRC generally accepts that the company would be trading when the intention moved from investment to trading. Furthermore, although prima facie a corporation tax liability would have been triggered on the appropriation from an investment asset to trading stock, an election can be made to effectively defer this chargeable gain into the ultimate trading profit. In this way, shareholders can, in certain circumstances, enjoy ER in respect of what in commercial terms are investment gains.

Associated disposals

It is still possible to enjoy ER in respect of disposals of assets which are used by ER qualifying companies. The main conditions at TCGA 1992 s 169K are as follows:

- The property needs to be used in a company's trade for the year ending with either the disposal of the company or the cessation of its trade (whichever is earlier).
- The company needs to qualify for ER when it is disposed.
- The disposal of the property needs to be linked with the disposal of the company's shares and needs to be part of the owner's withdrawal from participation.

Therefore, in practical terms, shareholders should be able to benefit from associated disposal treatment if they can trigger a disposal of some (although it now has to be at least 5%) or all of their shares; *and* (importantly) if the property is still being used by the company on the date of the disposal.

Although some fairly significant changes were introduced by FA 2015 in respect of associated disposals, the obscure 'killer blow' has now been unwound

Although some fairly significant changes were introduced by FA 2015 in respect of associated disposals, the obscure 'killer blow' has now been unwound. The headline rule was that at least 5% of shares need to be disposed of for there to be a 'material disposal'. However, a rule was also introduced which required that there is no 'share purchase arrangement' at the time when the share disposal takes place (TCGA 1992 s 169K(1B)(b)). The problem here was that any sale of shares to an individual *connected* with the shareholder would constitute a 'share purchase arrangement' and this would lead to ER being denied in respect of the sale of any property.

Fortunately, Finance Bill 2016 amended the position here, so that sales or gifts to family members should not jeopardise the relief. This brings into focus the fact that ER can still be enjoyed on asset disposals, even if a relatively small (5%) shareholding is disposed of. Furthermore, it is worth noting that this amendment was backdated to 18 March 2015, possibly putting some shareholders in a better tax position than they thought at the time of the disposal.

The ER rules on associated disposals are not quite as generous as the ER rules on share disposals. In contrast to share disposals, ER is restricted on associated disposals, by reference to the use of an asset throughout its ownership period. These restrictions are as follows:

- Restriction for any time during the property's ownership when it was not used for the purposes of the company's trade (for example, if it was not used for 10% of the ownership period, then only 90% of the gain would be eligible for ER).
- Restriction for any period that the property was owned when the company was not the shareholder's 'personal company' (in other words, any period that the ER conditions would not have applied).
- Restriction in respect of periods since 5 April 2008 to the extent that the company was required to pay market rent to occupy the property (e.g. if 50% of market rent was payable, then the restriction would only apply to 50% of the post 5 April 2008 gain).

Interestingly, a harsh reading of this legislation can end up with the conclusion that there would be a restriction for periods when a property is used by a sole trader business prior to its incorporation. We have concluded recently that HMRC would be unlikely to take this point and also that it can be defended on a 'just and reasonable basis', as outlined in the legislation (TCGA 1992 s 169P).

Statutory ER relaxations

We have seen a few cases where the scope of ER has been widened. One such instance was when shares from EMI options were brought much more firmly within the ER net from 5 April 2013. Essentially, this meant that employees could benefit from ER on disposals of shares derived from EMI options if over 12 months had elapsed between option grant and sale of the shares. Previously, 'EMI profits' were typically taxed at 28%, due to the fact that employees often could not meet the 5% requirement and/or had not held the shares for 12 months. Although this was a welcome relaxation, all that was really happening was that the treatment was being restored to that which had prevailed in the BATR era.

In a similar way, perhaps we should not get too excited by the introduction of the new 'investors' relief'. Investors' relief offers the same 10% CGT rate as ER, and is subject to a lifetime limit of £10m. The investor need not be an employee or hold office, but must hold their shares for at least three years, rather than the 12 months required by ER. The investment must be in newly issued ordinary shares (issued on or after 17 March 2016) in an unlisted trading company or an unlisted holding company of a trading group. They must be held continually for three years starting from 6 April 2016.

It will be interesting to see how widely used investors' relief is. It doesn't offer the complete exemption from CGT, deferral relief, or the income tax relief which is associated with EIS and SEIS; it may, though, prove useful where a company does not qualify for EIS status. EIS conditions are stringent and have become more so, for example with the recent (general) limitation to companies less than seven years old.

Because the ER rules are already generous with regards to the employment or office holding condition – there is no minimum working time requirement, as there is for EMI – then many investors with a stake of 5% are likely to want at least a non-executive role so they qualify for ER, given the shorter holding period requirement. For those investing in smaller stakes, this relief could be useful but probably only in circumstances where EIS would not be applicable.

Lessons from case law: watch out for simple mistakes

Although we could spend time dwelling on opportunities that have been taken away, recent cases should remind advisers of the importance of not making a mess of the basic rules. These are summarised below. In the first two cases that follow, the ER conditions were breached by what were essentially simple oversights. In the third case, the ER conditions were held not to have been breached, but the judge was careful to explain their view was confined to the particular circumstances of that case.

J K Moore: failed claim

A recent tribunal case, *J K Moore v HMRC* [2016] UKFTT 115 (TC), illustrates how forgetting small details can lead to very costly tax consequences when making a claim for ER.

John Moore was a 30% shareholder in Alpha Micro Components Ltd (Alpha). During 2008, there was a disagreement amongst the shareholders over the direction of the business, resulting in Mr Moore agreeing to leave. The parties agreed to enter into a compromise agreement for the termination of Mr Moore's employment, and for Alpha to buy back his shares. Forms were filed at Companies House, stating that the director had resigned on 28 February 2009. However, the company did not resolve to repurchase his shares until 29 May 2009.

As mentioned above, ER conditions require that the shareholder is an officer or employee of the company throughout the period of one year ending with the date of the disposal. HMRC successfully contended that Mr Moore failed these conditions by virtue of his earlier resignation from the company. Mr Moore claimed that the disposal of his shares was effective from the date of the compromise agreement, on the basis that there was an unconditional obligation for the company to buy back his shares. In dismissing this argument, the tribunal noted that the Companies Act 2006 requires there to be a special resolution passed before a purchase of own shares can validly take place. As a matter of fact, this did not take place until 29 May 2009 and so the company was incapable of entering into a valid contract any earlier than this.

Castledine: deferred shares

In *A Castledine v HMRC* [2016] UKFTT 145, Mr Castledine was a founder shareholder of Park Resorts, one of the UK's largest operators of caravan parks. In 2007, Mr Castledine retired, and the company was taken over by Dome Holdings Ltd (DHL) for a mixture of cash and loan notes. In his absence, however, the business failed to prosper, resulting in Mr Castledine being called back a year later. The turnaround was successful, but it required a restructuring of the group's finances, in which Mr Castledine was allocated 5% of the ordinary share capital.

Between July 2011 and July 2012, Mr Castledine disposed of his loan notes, giving rise to capital gains. However, he claimed ER on the basis that he also held 5% of the ordinary share capital (as required by the legislation). On enquiry by HMRC, it noted that whilst Mr Castledine held exactly 5% of the ordinary 'A' and 'B' shares in the company, there was also a third class of 'deferred shares' in existence. If these shares also formed part of the 'ordinary share capital', then Mr Castledine's shares would only equate to a 4.99% shareholding. The deferred shares had been created as a mechanism for removing ordinary 'B' shares from senior managers of DHL on their departure. The deferred shares had no voting rights or rights to dividends, and only had a right to redemption at par if £1m had been paid out on every 'B' share (which, given there were 20 million 'B' shares would never conceivably happen!). In other words, they were worthless and had largely been forgotten about.

> The decision in *McQuillan*, in stark contrast to *Castledine*, found that shares with no dividend rights were effectively fixed rate shares, falling outside the definition of 'ordinary share capital'

Unfortunately in the tribunal, the judge, while sympathetic to the commercial reasons for creating the deferred shares, was unable to agree that they were anything but ordinary shares on a plain reading of the legislation. The ER conditions were therefore not met, resulting in the gain being taxable at the main 28% rate of CGT.

On a positive note, this case seems to lend support to the effectiveness of scenarios whereby shareholders subscribe for low value shares in order to achieve a 5% holding of share capital. Given the strict definition of capital used in the *Castledine* case, it is difficult to see how HMRC could succeed in any argument seeking to ignore low value

'dummy shares' when considering the availability of ER.

However, the decision on the *McQuillan* case found, in stark contrast to *Castledine*, that shares with no dividend rights were effectively fixed rate shares, falling outside the definition of 'ordinary share capital'.

McQuillan: ordinary share capital and shares with no entitlement to dividends

In *M McQuillan and E McQuillan v HMRC* [2016] UKFTT 305, Mr and Mrs McQuillan each held 33 £1 ordinary shares in a company incorporated in 2004 with 100 £1 shares. Mr and Mrs Pennick each held 17 shares and had also lent the company £30,000, interest free, disclosed in the accounts as a directors' loan. In early 2006, the company was offered a grant by Invest Northern Ireland on the precondition that the Pennicks' directors' loans be converted to shares. Accordingly, in 2006, the loan was converted to redeemable, non-voting shares of £1 each. As a result the company had 30,100 £1 shares in issue, divided into 100 voting shares and 30,000 non-voting shares. The Pennicks each held 15,000 non-voting shares in addition to their 17 voting shares. Although the shareholders' agreement was silent on dividends other than that any dividends would be paid to the shareholders, the shareholders had always agreed and understood between themselves that the 30,000 redeemable shares would carry no right to any dividends and conferred no rights of ownership over the business, representing merely an interest free loan.

The redeemable shares were redeemed at par just prior to a sale of the company in 2009. HMRC challenged the McQuillans' subsequent claims for ER on the disposal of each of their 33 shares on the basis that, for part of the one year qualifying period, they each held only 0.001% of the ordinary share capital, i.e. 33 shares each out of 30,100 shares in issue.

HMRC argued that shares which had no right to a dividend were not shares 'the holders of which have a right to a dividend at a fixed rate' and therefore were 'ordinary share capital' for the purposes of ITA 2007 s 989. The McQuillans contested that the redeemable shares did have a fixed right to a dividend – of 0%.

The tribunal recognised the McQuillans' 'compelling' argument that had the loan not been made interest free, then the shares would have been issued with a fixed dividend of a positive amount and if this was so, then there was no reason for treating an interest free loan any differently to a loan which is subject to interest – as such it was difficult to see why the redeemable shares in question should be treated any differently when the only difference was having a zero, rather than nominal fixed dividend. These factors, including the precondition of the grant from Invest NI and (to a lesser extent) the timing of the share issue, which pre-dated the introduction of ER, persuaded the tribunal that *in the particular circumstances* 'a right to no dividend is a right to a dividend at a fixed rate for the purposes of that definition'.

Whether this decision is appealed (particularly in the light of *Castledine*) remains to be seen, but this emphasises the importance of scrutinising the basic requirements of ER. A nominal fixed rate dividend of, say, just 0.1%, would have taken the redeemable shares firmly outside the definition of ordinary share capital and avoided the challenge to ER.

Mistakes that we have seen

In a similar vein to the cases above, we have come across 'mistakes' that have failed to maximise the availability of ER. For example, it is quite common for shareholders to gift shares to their spouses to allow them to make use of their spouses' lower tax rates on receipt of dividends. Often, these spouses will not be officers or employees of the company and would therefore not qualify for ER. This issue can be addressed simply by the non-active spouse transferring shares to the active spouse prior to a disposal. It is a common fallacy that these shares then need to be held for a year before disposal for 'them' to qualify for ER. This is incorrect, as long as the active spouse's shareholding met ER conditions. To avoid this issue arising, it is often good practice to make the non-active spouse either a director or a secretary of the company. Shareholders will be kicking themselves if their spouses end up being denied ER.

The above planning would not work if the active shareholder exceeds his or her £10m lifetime allowance and a sale is imminent. In this case, shares should be transferred to the non-active spouse over a year before disposal; *and* he or she should be an officer or employee of the company for that period.

This is all very basic planning, which is highly effective and generally inoffensive to HMRC. This makes it all the more regretful when things go wrong.

Final thoughts

Legislation has now to some extent limited a shareholder's ability to enjoy capital treatment (and hence ER) on 'proceeds' which arise from anything other than a straightforward sale to a third party. Time will tell how much of a practical impact any new legislation will have and how draconian or lenient HMRC will be in practice.

Currently, there is no clear reason why ER cannot be enjoyed in respect of the sale of a company which is 'pregnant' with reserves, but it may be a case of 'watch this space'

In the meantime, we are still left with what is essentially a very generous set of rules, which if used carefully can enable ER to be enjoyed in a wide variety of scenarios. In some cases (for example, where liquidations are involved), more time may need to be spent clarifying the position at the outset with HMRC, but we hope that a positive outcome would be achievable in a large proportion of these cases.

Currently, there is no clear reason why ER cannot be enjoyed in respect of the sale of a company which is 'pregnant' with reserves, but it may be a case of 'watch this space'. ■

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