THE RELATIONSHIP BETWEEN ENTREPRENEURS' RELIEF AND OTHER CAPITAL GAINS TAX RELIEFS

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Introduction

Tax practitioners will be familiar with the principle that ill-conceived legislation leads to subsequent difficulties – the phrase 'act in haste, repent at leisure' indeed has a particular ring to it when the act referred to therein is a Finance Act. For this reason, practitioners must undoubtedly be grateful that, amongst the reams of new tax legislation that has been thrust upon the nation in recent years, much of it has been subject to prior consultation. Nevertheless, despite paying lip service to the idea of consultation, politicians still often think that they know better than the experts and decide to commit themselves to policy changes without fully thinking through the consequences.

A recent example is the Chancellor's announcement in October 2007 heralding the simplification of the capital gains tax régime.[2] I have no doubts that simplification should be welcomed although, personally, I do fail to see why a flat-rate of tax (irrespective of personal circumstances) is so necessary, when a fairer system (aligning the rate with the income tax rates – even if capital gains are to be subject to some form of discount) is only slightly more complicated and was not the main cause of complexity in the legislation.

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2 Indeed, my two previous articles have already considered some of the consequences of the changes made by the Finance Act 2008.

This article considers one of the consequences of the Chancellor's ill-fated announcement – the introduction of (so-called) entrepreneurs' relief.[3] As part of the simplification process, the Finance Act 2008 repealed the provisions that provided for the taper relief rules.[4] As was well understood, under the taper relief rules, a person who had owned a business asset for two or more years would be entitled to an exemption of 75% of any gain arising on the disposal of the asset (in theory, at least, even if not in practice). With a top tax rate of 40%, this meant that business assets could often be disposed of with an effective tax rate of no more than 10%.
By introducing a flat tax rate of 18% and the simultaneous withdrawal of taper relief, the Chancellor found himself facing protests from individuals who were about to see a near doubling of their tax liabilities arising from the disposal of their businesses. After denials and then broken promises, the Chancellor eventually announced that he would introduce a modest relief (covering gains of up to £1m) which would roughly replicate the previous 10% rate. This relief, known as entrepreneurs' relief, broadly reduces a qualifying gain by the fraction of $^4/_9$ so that, with the remaining five-ninths being taxed at 18%, there is an effective rate of 10%. As will often be the case with capital tax legislation, the rules providing for the relief have to operate in tandem with other reliefs under the code. This article will consider how the different reliefs co-operate with entrepreneurs' relief.

How entrepreneurs' relief operates

The rules have been inserted as Chapter 3 of Part 5 of the Taxation of Chargeable Gains Act 1992.[5] The Chapter has been shoe-horned between sections 169G and 170 and consists of sections 169H to 169S.

Section 169H provides an introduction to the Chapter, introducing some of the key concepts. Sections 169I to 169K deal with the three types of disposal on which entrepreneurs' relief is available (very broadly, disposals of businesses themselves (section 169I), an inferior equivalent for disposals by trustees (section 169J) and disposals associated with the disposal of a business (for example, the disposal of premises used by a company) (section 169K)).

Soon one comes to the two key sections for the purposes of this article: sections 169M and 169N. Superficially, they are no more than procedural provisions, providing that entrepreneurs' relief is an optional relief in that one must make a

3 I refer to the relief as 'Entrepreneurs' relief' solely because that is how it is referred to by the legislation. It assists real entrepreneurs no more than the definition of a business asset adequately covers all assets that might be used in a business.

4 I note in passing the irony of the fact that the introduction of taper relief was described in the Inland Revenue Press Release IR16 (Budget Day 1998) as one that would "lead to simplification of the CGT system".

5 All statutory references in this article are to that Act.

timely claim for the relief (section 169M) and section 169N provides that the relief reduces gains by the fraction of $^4/_9$ as previously mentioned. However, those two sections also contain the essence of the Chapter and determine how the relief really operates.

For this reason, the two sections are reproduced below.

169M Relief to be claimed

(1) Entrepreneurs' relief is to be given only on the making of a claim.

(2) A claim for entrepreneurs' relief in respect of a qualifying business disposal must be made—

(a) in the case of a disposal of trust business assets, jointly by the trustees and the qualifying beneficiary, and

(b) otherwise, by the individual.

(3) A claim for entrepreneurs' relief in respect of a qualifying business disposal must be made on or before the first anniversary of the 31 January following the tax year in which the qualifying business disposal is made.

(4) A claim for entrepreneurs' relief in respect of a qualifying business disposal may only be made if the amount resulting under section 169N(1) is a positive amount.

169N Amount of relief: general

(1) Where a claim is made in respect of a qualifying business disposal—

(a) the relevant gains (see subsection (5)) are to be aggregated, and

(b) any relevant losses (see subsection (6)) are to be aggregated and deducted from the aggregate arrived at under paragraph (a).

(2) The resulting amount is to be reduced by 4/9ths.

(3) But if the aggregate of—

(a) the amount resulting under subsection (1), and

(b) the total of the amounts resulting under that subsection by virtue of its operation in relation to earlier relevant qualifying business disposals (if any),

exceeds £1 million, the reduction is to be made in respect of only so much (if any) of the amount resulting under subsection (1) as (when added to that total) does not exceed £1 million.

(4) The amount arrived at under subsections (1) to (3) is to be treated for the purposes of this Act as a chargeable gain accruing at the time of the disposal to the individual or trustees by whom the claim is made.

(5) In subsection (1)(a) "relevant gains" means—

(a) if the qualifying business disposal is of (or of interests in) shares in or securities of a company (or both), the gains accruing on the disposal (computed in accordance with the provisions of this Act fixing the amount of chargeable gains), and

(b) otherwise, the gains accruing on the disposal of any relevant business assets comprised in the qualifying business disposal (so computed).

(6) In subsection (1)(b) "relevant losses" means—

(a) if the qualifying business disposal is of (or of interests in) shares in or securities of a company (or both), any losses accruing on the disposal (computed in accordance with the provisions of this Act fixing the amount of allowable losses, on the assumption that notice has been given under section 16(2A) in respect of them), and

(b) otherwise, any losses accruing on the disposal of any relevant business assets comprised in the qualifying business disposal (so computed, on that assumption).

(7) In subsection (3) "earlier relevant qualifying business disposals" means—

(a) where the qualifying business disposal is made by an individual, earlier qualifying business disposals made by the individual and earlier disposals of trust business assets in

respect of which the individual is the qualifying beneficiary, and

(b) where the qualifying business disposal is a disposal of trust business assets in respect of which an individual is the qualifying beneficiary, earlier disposals of trust business assets in respect of which that individual is the qualifying beneficiary and earlier qualifying business disposals made by that individual.

(8) If, on the same day, there is both a disposal of trust business assets in respect of which an individual is the qualifying beneficiary and a qualifying business disposal by the individual, this section applies as if the disposal of trust business assets were later.

(9) Any gain or loss taken into account under subsection (1) is not to be taken into account under this Act as a chargeable gain or an allowable loss.

The first thing to note is that entrepreneurs' relief operates on what the legislation calls a 'qualifying business disposal'.[6] As implied by section 169N(1), (5) and (6), but confirmed by sections 169H to 169K, a qualifying business disposal will often involve more than one transaction that would on its own constitute a separate disposal for capital gains tax purposes. To take the simplest (and, probably, the most common) example, section 169H(2)(a) provides that a 'material disposal of business assets' can constitute a qualifying business disposal. Section 169I then provides as follows:

(1) There is a material disposal of business assets where—

(a) an individual makes a disposal of business assets (see subsection (2)), and

(b) [not relevant for this article].

(2) For the purposes of this Chapter a disposal of business assets is—

(a) a disposal of the whole or part of a business,

(b) a disposal of (or of interests in) one or more assets in use, at the time at which a business ceases to be carried on, for the purposes of the business, or

6 sections 169M(2)

(c) a disposal of one or more assets consisting of (or of interests in) shares in or securities of a company.

Thus, leaving aside the possibility that the qualifying business disposal is actually a disposal of an individual's shareholding in a company, a qualifying business disposal will often consist of more than one chargeable disposal. For example, the sale of an unincorporated business might involve the disposal of more than one business premises or the disposal of premises together with goodwill.

Ordinarily, such disposals are considered separately when it comes to capital gains tax, with proceeds and allowable costs etc being ascertained for each individual asset. However, the entrepreneurs' relief rules clearly provide that the set of disposals must be considered as one when ascertaining the relief. In particular, the relief operates on the total gains less the total losses arising on the qualifying business disposal.[7] More importantly, the effect of section 169N(4), (9) is to treat the total net gain (as reduced by the fraction of $^4/_9$) as if it were a standalone chargeable gain and, conversely, any chargeable gains or allowable losses arising on the individual component disposals (i.e. the different premises, the goodwill etc) as if they were not such gains or losses.

It is with this in mind that it is then appropriate to consider the other relevant capital gains tax reliefs.

The reliefs considered

The reliefs to be considered by this article are EIS deferral relief, rollover relief, gift (holdover) relief and incorporation relief.

EIS deferral relief

Under Schedule 5B to the Taxation of Chargeable Gains Act 1992, any chargeable gain arising on a disposal may be deferred if (*inter alia*) the person making the disposal makes an investment in shares qualifying for relief under the Enterprise Investment Scheme. Paragraph 2 provides that the gain (or any specified part of the gain) may be postponed until some later occasion.

It is generally accepted that the deferral relief operates after the benefit of any entrepreneurs' relief in that the deferral rules operate to sweep up any remaining

7 For this reason, it will often be better to dispose of those assets standing at a loss outside a qualifying business disposal because the value of the loss is otherwise reduced by the fraction of 4/9 (subject of course to the net gains being less than £1m). There are some concerns that different disposals effected at different times might be aggregated under these rules. However, that issue is not considered further in this article.

gain; this would seem to make sense from a policy perspective and this is the approach taken by HMRC.[8]

However, this is not simply because the legislation fits together nicely; it is because paragraph 1(1)(b) of Schedule 5B was specifically amended to operate in respect of the chargeable gains deemed to arise under section 169N(4). But can the reliefs operate in the opposite way – i.e. can some of the gains arising from a qualifying business disposal be subject to EIS deferral relief ***before*** being subject to a subsequent claim for entrepreneurs' relief?

It is hard to see when such an approach would be of any benefit to individuals: it would involve substituting what is at best a deferral for a four-ninths exemption and, in such cases, the optimum outcome will generally be to take advantage of the entrepreneurs' relief and defer the balance. And where the £1m cap on the relief is exceeded, it will make no difference in which order the reliefs are to be taken.

The legislation is not free from doubt and care should therefore be taken to ensure reliefs are taken in the correct order to avoid unnecessary arguments with HMRC.[9] However, I would suggest that the better view is that any claim for deferral relief cannot affect the amount of the gains that may be taken into account for the purposes of entrepreneurs' relief. This is because the latter is determined by section 169N(5) which refers to the gains "computed in accordance with the provisions of this Act fixing the amount of chargeable gains". In other words, one has to identify the chargeable gains accruing on the disposal. Whilst paragraph 2(2) of Schedule 5B provides that any part of a gain which is subject to deferral relief is treated as not accruing at "the accrual time", I would suggest that this merely defers the *time* at which the gain accrues: it does not prevent the gain from accruing *on the disposal*. Thus, any claim for entrepreneurs' relief will operate on the totality of any gain arising and will take precedence over any previous claim for deferral relief.

Rollover relief

Analysis of the rules for rollover relief give the opposite result. Rollover relief (under section 152) provides that any gain arising on the disposal of a business asset can be deferred if the business asset is replaced. It operates by reducing the capital gains tax base cost of the replacement asset so that, effectively, the deferred (or rolled over) gain crystallises upon the disposal of the replacement asset, by virtue of an increased chargeable gain arising upon the latter's disposal.

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8 Capital Gains Manual CG64135

9 Whilst their guidance would seem to preclude (without an announced change in policy) a straightforward U-turn, in these straitened times it is not difficult to imagine challenges from HMRC in cases where a claim for deferral relief is made before Entrepreneurs' relief is claimed.

In the straightforward case, section 152(1)(a) provides that the disposal proceeds received for the old asset are reduced (so as to equal the allowable costs)[10]. Therefore, when section 152(1) applies, no gain arises. Consequently, there is no gain to be plugged into the section 169N computations.

Given that a claim for entrepreneurs' relief needs to be made within 21 months of the end of the tax year in which a disposal takes place, whereas rollover relief can apply in relation to disposals up to three years afterwards (or even later, if permitted by HMRC)[11], it will often be the case that a claim for the former will be made before a claim for the latter. However, the legislation provides that any claim for rollover relief will override any prior claim for entrepreneurs' relief because, under section 152(4), once an unconditional contract for the acquisition of the replacement asset or assets is entered into and the asset (or assets) is acquired in pursuance of the contract "all necessary adjustments shall be made by making or amending assessments or by repayment or discharge of tax … notwithstanding any limitation on the time within which assessments or amendments may be made". In other words, the claim for rollover relief will have the effect of reducing the disposal proceeds so as to eliminate any gain arising, meaning the reduction (or elimination) of any gain otherwise qualifying for entrepreneurs' relief.

Section 153 deals with cases where the reinvested amount is less than the consideration received for the old assets. In such cases, the gain on the disposal is not eliminated (as would be the case under section 152): instead, it is proportionately reduced. So, unlike the case with section 152, the relief does not strike at the consideration but merely at the gain itself. However, so far as the interaction of reliefs is concerned, the outcome is the same. This is because the rollover relief under section 153 modifies the gain arising on the disposal of the old asset, thereby modifying any gain for the purposes of section 169N. The effect of section 152(4) is preserved for the purposes of section 153 by section 153(2).

Again, the HMRC view is in accordance with this interpretation[12].

Gifts (holdover) relief

For the same reason, it would appear that a claim for relief under either section 165 or 260 would generally take precedence over any subsequent claim for entrepreneurs' relief. Sections 165(4)(a) and 260(3)(a) both modify the amount of the gain that accrues on the disposal of the asset in question. Consequently, it will

10 with section 152(1)(b) making a corresponding deduction to the base cost of the replacement asset

11 section 152(3)

12 at CG64136

be the modified gain arising on the asset that will be plugged into the section 169N computation, where appropriate. So far, this accords with the HMRC guidance.[13] However, unlike the position for rollover relief, however, the gifts relief rules do not contain any general provision that claims for relief will lead to all necessary adjustments.[14] Therefore, there is no explicit provision that caters for the situation whereby a claim for entrepreneurs' relief is made and it is subsequently decided to make a claim for holdover relief in respect of one or more of the component gains. (It will be noted that gifts relief claims may be made nearly six years after the year of the disposal (to be reduced to four years from 1 April 2010), somewhat longer than the period in which entrepreneurs' relief must be claimed.)

Whereas section 153 (the closest relative to sections 165 and 260 in terms of legislative wording) operates by reducing the amount of the gain accruing on the disposal without any qualification, sections 165(4)(a) and 260(3)(a) expressly limit their effect to reducing "the amount of any chargeable gain which, apart from [that] section, would accrue to the transferor on the disposal". Furthermore, section 169N(9) provides that any gain taken into account for the purposes of entrepreneurs' relief is not to be taken into account for the purposes of the Act as a chargeable gain. Thus, once a gain has been used for the purposes of entrepreneurs' relief, it would seem that it could not be taken into account subsequently for the purposes of sections 165 and 260.

Incorporation relief

The most difficult relief to reconcile with entrepreneurs' relief is incorporation relief under section 162.[15] This is because, as with entrepreneurs' relief itself, the relief does not operate on an asset-by-asset basis, but on the amount reached by aggregating both the gains and losses and deducting the latter from the former. Thus, both reliefs operate at a stage beyond that of computing the gains and losses on the individual component disposals.

However, despite the difficulties, it is another combination of reliefs that is likely to be valuable in practice if the two can in fact co-exist.[16] The question, then, is

13 at CG64137

14 On the contrary: they both contain provisions that deal with subsequent variations to the inheritance tax position of the donor.

15 This might be the reason why HMRC choose not to address the issue in their manuals.

16 It will surely be common for businesses to incorporate and claim entrepreneurs' relief whilst it is available and seek to rollover the balance into the cost of the new shares.

whether the two reliefs can be claimed in respect of the same transaction.[17]

When incorporation relief is claimed, the relief operates in a purely computational fashion, leaving unaffected any gains or losses arising from the component disposals. This is in direct contrast to the position with entrepreneurs' relief where the component disposals cease to be chargeable gains or allowable losses.[18] It is suggested that this is the key to the question about the two reliefs' interaction.

The other relevant distinction between the two reliefs is that section 162 is not subject to any claim (though, it is now possible to elect for section 162 not to apply[19]). Therefore, there can never be a situation in which a taxpayer has claimed relief under section 162 and is subsequently considering a claim for entrepreneurs' relief.

Section 162(2) operates by deducting the relief from the sum of the chargeable gains less the allowable losses, meaning the net effect of the various component disposals in the transaction. However, section 169N(9) provides that any such component ceases to be taken into account for the purposes of the rest of the Act as a chargeable gain or allowable loss. So, if a claim for entrepreneurs' relief is made, there is an argument that incorporation relief will not be available on the balance of any gains. However, the deemed chargeable gain arising under section 169N(4) will, arguably, act as "the aggregate of the chargeable gains less allowable losses" for the purposes of section 162(2) and so it is this post-entrepreneurs' relief figure that forms the basis of the operation of incorporation relief.

As taxpayers can rarely be sure whether a capital gains tax relief will be available from one year to the next, it will often be prudent to claim reliefs whilst they are available. This is particularly true in cases where an unincorporated business is being transferred to a limited company. Even though incorporation relief will (often) ensure that no capital gains tax is payable at the time of the incorporation, the relief merely delays the inevitable. In such cases, it will often be appropriate to bank entrepreneurs' relief whilst it is available. If the relief is subsequently withdrawn from the statute, then the decision will probably prove wise. In other cases, the

17 It will be noted that, for the two reliefs to be in issue in respect of the same transaction, there must be the disposal of the entirety of a business together with all the assets of the business (with the possible exception of cash) (section 162(1)). Such a disposal will qualify as a material disposal of business assets under section 169I(2)(a), (b). The converse will not always be the case: there will be material disposals of business assets that do not qualify for relief under section 162.

18 section 169N(9). One could ask how incorporation relief is actually given because there seems to be no legislative facility to give effect to the reduction. However, section 162(2) suggests that the net gains arising on the disposal of the business are considered as a sub-total which is reduced by the amount of the relief before other gains and losses for the year are taken into account.

19 section 162A

taxpayer is likely to be no worse off. However, this course of action is subject to the risk that HMRC ever argue that incorporation relief is not available once entrepreneurs' relief has been claimed.

Conclusion

In summary, it would appear that:

- EIS deferral relief will operate after any claim for entrepreneurs' relief;
- rollover relief claims take priority over any entrepreneurs' relief;
- gifts relief and entrepreneurs' relief can be combined if a claim for gifts relief is given effect first, but a prior claim for entrepreneurs' relief precludes any subsequent claim under section 165 or 260; and
- entrepreneurs' relief takes priority over incorporation relief, which will operate on the balance of any relevant gains.

However, the legislation is not without inherent uncertainties, mainly because the various reliefs were drafted at different times and therefore without their interaction as the drafter's first priority. The Tax Law Rewrite Project, had it been preserved long enough to turn its attention to capital gains tax, would not necessarily have solved all the mysteries but its team members would undoubtedly have spent many valuable hours unravelling some of the threads. However, the Project's demise will mean that certainty will be achieved only through amending legislation, litigation or by a clear statement of practice which will give taxpayers a favourable interpretation.