EXIT STRATEGY

Entrepreneurs' relief provides a beneficial 10% tax rate on owner manager exits but the benefits can be lost through bad planning, says Peter Rayney

Entrepreneurs' relief (ER) is probably the most valuable tax break available to owner managers. It enables them to sell 'their' company at a modest 10% capital gains tax (CGT) rate on gains of up to £10m. With a main CGT rate of 28%, this means that ER produces a maximum tax saving of £1.8m, ie, £10m x 18% (28% less 10%).

However, the benefits of ER can be eroded by the lack of diligent planning and failing to recognise the subtleties in the way the rules work in relation to various sale structures. Outlined below are 10 tips to ensure that the savings available under the ER regime are maximised.

Unless stated otherwise, all statutory references are to the Taxation of Chargeable Gains Act 1992.

TIP 1: Is your company a qualifying trading company?

Most companies will easily meet the ER requirement to be a 'qualifying trading company or holding company of a trading group' within the one year prior to the share disposal. However, some profitable companies seek to invest their surplus funds in property or other types of investment. If substantial amounts are directed towards investment activity, the relevant company may fail the (relatively stringent) ER 'trading' requirement in s165A (see s169S (5)).

For ER purposes, the relevant company/group must be entirely trading subject to an important de minimis rule that enables 'non-substantial' investment activities to be ignored (s165A (3)).

The assessment of a company's ER trading status can be a subjective exercise. However, HMRC has indicated that it would apply a '20% test' when assessing whether the investment activities were substantial. This 20% benchmark would be applied across a wide range of measures, including:

- turnover;
- the asset-base;
- expenses; and
- time spent by management and employees.

Thus, for example, the turnover/sales income from non-trading activities would be compared with the total turnover generated by the company and so on. It may be necessary to build up the correct picture over time and this may involve striking a balance between all these factors (*IR Tax Bulletin*, Issue 62, December 2002). There is also a view that the profit and loss account provides a better measure of 'activity' than a balance sheet, and therefore more weight should be given to a company's turnover, income and employee costs.

£1.8m

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While the 20% de minimis rule adopted by HMRC provides a helpful 'safe-harbour' test to apply in practice, it should not be taken as a definitive statutory test.

In marginal cases, the precedents established by *Farmer & Giles (Farmer's Executors) v CIR* [1999] SSCD 321 and *HMRC v Brander (as executors of the will of the late Earl of Balfour)* [2010] UKUT 300 can be helpful, which essentially require us to look at the business 'in the round'. Interestingly, in the *Brander* case, the Upper Tier Tax Tribunal placed far greater weight on turnover, profitability and the activities of the employees rather than the capital employed on each business activity.

TIP 2: What about companies carrying excess cash balances?

Although care still needs to be taken with

'excessive cash balances', HMRC now seems to adopt a more lenient approach. HMRC tends to accept that cash generated from trading activities should not necessarily prejudice a company's 'trading' status. It takes the view that any surplus cash would have to be actively 'managed' before it was considered to be a 'non-trading'/investment activity of the business.

However, if cash balances are applied and managed as 'investment' assets, HMRC will treat them as 'non-trading' items and would therefore be subject to the 20% 'safe harbour' rule.

In some cases, if it is clearly surplus to the current or future needs of the business, it may be prudent for the cash to be 'extracted' by the shareholders to avoid potential future loss of ER.

TIP 3: Obtaining certainty about the company's trading status for ER purposes

There will be cases where it can be difficult to reach a firm conclusion as to whether the 'target' company/group meets the 'trading' test for ER. The company may have significant funds tied up in investment property or perhaps has made large loans to individuals/(non-group) companies and so on.

Where a sale is being contemplated, owner managers will require some certainty that their ER will not be prejudiced by the existence of investment assets or surplus cash balances. In such cases, they should seek a ruling from HMRC under the non-statutory business clearance procedure. Broadly speaking, this entails setting out the technical concerns by 'putting all the cards on the table' and then providing a reasoned basis for showing that the target company should meet the ER 'trading' company/group test.

HMRC has indicated that they will deal with these applications reasonably promptly (within a self-imposed deadline of 28 days). A satisfactory clearance enables the seller to proceed with confidence that they will benefit from the favourable ER CGT rate on the sale.

TIP 4: Do the owner manager and 'other' shareholders satisfy the 5% voting/ordinary share capital requirement?

Owner managers would expect to (easily) satisfy the 'personal company' conditions in the 12 months leading up to the disposal of their shares. However, it is easy to forget that TCGA 1992, s169S(3), requires the seller to hold at least both 5% of the ordinary shares and 5% of the voting rights. There are no 'associate' rules here so the 5% holding must be held by the shareholder in their own right.

It is important to appreciate that virtually all types of shares will constitute ordinary shares for these purposes even if they are non-voting (the only exception being fixed rate preference shares (see s989 ITA 2007, and s169S). Thus, where the company has more than one class of shares, a check should always be made to ensure that the shareholders economically entitled to the capital gain on sale retain (at least) 5% of the total ordinary share capital (measured in terms of nominal value).

Owner managers should ensure that key shareholders will not be prejudiced by the subsequent exercise of EMI share options

TIP 5: Beware of the dilutive effect of 'exit-based' EMI options

Similar 'dilution' problems can arise where the target company has previously granted Enterprise Management Incentive (EMI) options, which are exercisable on a later sale of the company. Typically, the employees would exercise their options to acquire their EMI shares shortly before the sale.

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If the company has a reasonably fragmented shareholding base, with perhaps some shareholders only being on the 'cusp' of the 5% ER ordinary share capital holding (say 5% to 8%), the pre-sale exercise of the EMI options may have the effect of diluting their proportionate shareholding below the all-important 5%. This would mean that the necessary 5% holding has not been held throughout the 12 months ending with the disposal.

HMRC has confirmed that this adverse dilutive effect on the existing shareholders can only be ignored if exceptionally the EMI options are exercised on the same day as the sale of the company.

Owner managers should take into account the dilutive effect of the EMI options so as to ensure as far as possible that key shareholders will not be prejudiced by the subsequent exercise of EMI share options.

TIP 6: Can EMI option shares qualify for EMI?
As a result of legislative changes to be confirmed in Finance Bill 2013, where the EMI shares are acquired under option after 5 April 2012 and sold after 5 April 2013, they will qualify for the 10% ER CGT rate, irrespective of the size of the shareholding.

The revamped rules particularly benefit 'exit-based' EMI share options since they would not normally qualify (due to the general 'one year' ER shareholding rule). However, Finance Bill 2013 will provide that the one-year ER holding period can start from the date the EMI option is granted (where this is appropriate). The other ER 'trading' and 'employment/officer' tests must be met throughout this period.

TIP 7: What happens where the purchasing company issues shares as part of the sale consideration?
Normally, where a purchaser offers shares as part of the sale consideration, this will be dealt with under the share for share exchange rules in s135 (provided the 'bona fide commercial purpose' test in s137 is satisfied). This brings the CGT reorganisation rule in s127 TCGA 1992 into play, which means the seller does not make any disposal of their old shares and is treated as receiving the new 'consideration' shares at the same time and cost as their old shares.

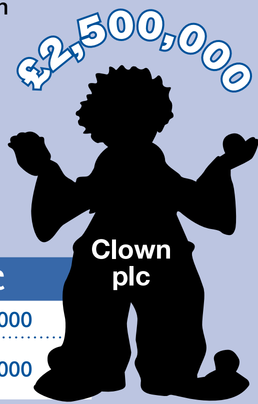
Because the 'reorganisation' rule provides there is no CGT disposal, the seller would not normally be able to claim ER on the sale consideration satisfied by shares in the purchaser. This would be unfortunate if the seller was unable to claim ER on a later sale of their 'consideration' shares – for example, because they did not possess the requisite 5% shareholding in the purchasing company.

EXAMPLE OF QCB LOAN NOTE CONSIDERATION AND THE s169R ELECTION

Emile: owner of Alford Ltd
Shares: 20,000 £1 shares

Emile has owned 100% of the share capital of Alford Ltd for many years, subscribing for 20,000 £1 ordinary (voting) shares at par when the company was formed in 1987. She has always been the managing director of the company, which is a trading company.

Since early 2012, Emile has been in negotiations with Clown plc, which is seeking to purchase a 100% stake in Alford Ltd. The total sale consideration for Emile's 100% holding in Alford Ltd has recently been agreed at £2,500,000, which is made up as follows:



	£
Cash consideration (on completion)	1,500,000
Clown plc 7% loan note (redeemable after 18 months), and structured as a QCB	1,000,000

Consequently, the seller can make a special election under s169Q to opt out of the normal share for share exchange rules. Where the election is made, the seller is treated as having made a normal CGT disposal with the value of the purchaser's shares being reflected in the overall sale consideration. This means that the seller pays tax at the 10% ER CGT rate on the value of the 'consideration' shares and hence benefits by taking the 'consideration' shares at their (higher) market value for future CGT purposes.

When deciding whether to make an s169Q election, sellers need to ensure they have sufficient cash consideration to fund the CGT liability on the 'share' element. The election is made on an 'all or nothing' basis and it is not possible to restrict its application to gains up to the (lifetime) ER threshold of £10m. Section 169Q elections must broadly be made within 22 months after the end of the tax year in which the sale occurs.

> **If substantial amounts are directed towards investment activity, the relevant company may fail the ER 'trading' requirement in s165A**

TIP 8: Dealing with sale consideration taken in the form of loan notes
Where the purchaser wishes to offer loan note consideration, this will normally be in the form of qualifying corporate bonds (QCBs). QCBs

The sale of Alford Ltd is expected to be concluded in March 2013.

If Emile makes an s169R election, the CGT liability on the sale of her shares is likely to be as follows (ignoring the annual CGT exemption):

	£
Cash	1,500,000
QCB (with s169R election)	1,000,000
Total consideration	2,500,000
Less: Base cost	(20,000)
Capital gain	2,480,000
ER CGT @ 10%	248,000

Capital gains tax on loan note: with an s169R election

If she does not elect, the gain on the loan note – £992,000 (£1,000,000 less pro-rata base cost £8,000) would be deferred and taxed at (probably) 28% in 2014/15.

Probable capital gains tax: without an s169R election

are not a chargeable asset for CGT purposes (s115(1)) and thus the relevant gain relating to the QCB consideration must be captured at the date of the share disposal. (The CGT reorganisation rules do not apply, see tip 7 above.)

Provided HMRC is satisfied that the sale transaction has been structured for genuine commercial reasons, section 116(10) provides that the QCB gain (or loss) is computed at the date of the share sale. This 'frozen' gain (loss) is carried forward and an appropriate part is subsequently taxed (or arises) when a corresponding part of the QCB loan note is disposed of (typically when it is repaid).

It is vital to appreciate that the postponed QCB gain does not carry any ER reduction. However, it is possible to obtain the benefit of the 10% ER CGT rate by making an s169R election, but this means giving up the right to defer the gain.

Under an s169R election, the seller effectively opts to disapply the s116 (10) deferral mechanism so that the seller's QCB consideration is treated as being given for the disposal of the 'old' shares – see worked example above.

Thus, assuming the seller qualifies for ER, they have a choice. Should they elect under s169R to enjoy an ER-CGT rate of 10% 'up-front' on the QCB gain or should they defer their gain under s116 (10) and (probably) pay CGT at 28% on the full held-over gain when the QCB is redeemed?

Although electing for 'CGT disposal' treatment accelerates the seller's CGT liability, the 18% tax saving will generally make this the preferred route.

However, sellers need to be aware of their tax cash flows when negotiating the terms of the sale transaction. By making the election, they will have to fund the CGT on both their cash and loan note consideration (which may still be fully or partly outstanding) by the 31 January following the tax year of sale.

TIP 9: Is it possible to unwind the s169R QCB election if the loan note becomes irrecoverable?

No, unfortunately, there is no statutory mechanism for unwinding the CGT disposal treatment if all or part of the QCB consideration becomes irrecoverable. The 'up-front' CGT charge still remains.

Consequently, if a seller anticipates making a 169R election, they should carefully consider the purchaser's creditworthiness. In some cases, it may be possible to obtain bank guarantees for the QCB loan notes, thus removing the 'bad debt' risk. Although some purchasers will resist providing bank guarantees (the amount guaranteed generally forms part of their borrowing facility), sellers are often advised to push for it and accept the inherent cost.

If the loan notes are short-dated ones, then it may be possible to keep the election open so that a 'wait and see' approach can be taken. The decision to make an s169R election would have to be made by the first anniversary of the 31 January following the tax year of sale (ie, just less than 22 months following the tax year of sale).

TIP 10: How does ER impact on earn-out deals?

With a cash-based earn-out arrangement, the value of the right to receive the earn-out is taxed as part of the initial sale consideration under the principles established in *Marren v Ingles* [1980] STC 500. Thus, assuming the seller has sufficient ER capacity, it makes sense to be more realistic about the initial valuation placed on the earn-out right.

The earn-out valuation is an important factor in 'splitting' the overall CGT charge on the deal between the ER CGT 10% rate (on the share sale) and the 28% rate on the subsequent earn-out gains. Thus, provided it can be substantiated under valuation principles, the higher the value of the earn-out right that can be agreed with HMRC, the greater the amount of tax that can be saved.

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