

TAXREP 30/08

Finance Bill 2008: Clause 7 and Schedule 3, Entrepreneurs' relief

Parliamentary Briefing on Entrepreneurs' relief submitted on 29 April 2008 by the ICAEW to the Finance Bill Standing Committee.

Contents	Paragraph(s)
Background	1 – 8
Detailed comments on Schedule 7	9 – 32
Further information	33

ICAEW Tax Faculty, Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ www.icaew.com/taxfac	T +44 (0)20 7920 8646 F +44 (0)20 7920 8780 E tdtf@icaew.com
--	--

Finance Bill 2008:
Clause 7 and Schedule 3, Entrepreneurs' relief

Background

- 1 Clause 7 and Schedule 3 enact the new 'entrepreneurs' relief', which was announced on 24 January 2008. This relief is based upon the Capital Gains Tax (CGT) retirement relief rules that were phased out beginning in 1999. It provides that gains of up to £1m on the disposal of all or part of a business are taxed at an effective rate of 10% rather than 18%.
- 2 The move to a flat-rate CGT is a potentially welcome simplification but will create winners and losers. In particular, many employee shareholders who previously would have qualified for the 10% CGT rate as their shares qualified as business assets will not qualify for entrepreneurs' relief and will therefore be faced with an 18% CGT rate. What is unclear is whether this constitutes a change in tax policy in relation to encouraging employee shareholders, given the less beneficial interaction with existing reliefs to encourage employee share ownership such as the enterprise management incentives (EMI) scheme.
- 3 Whilst we appreciate that this new relief includes a number of welcome simplifications as compared to the old retirement relief rules, those rules were not without problems and many of these have been re-enacted in the new relief. The rules for partnerships and companies are not identical, with the latter being generally more restrictive in that the shareholder must be an officer or employee and own 5% or more of the voting rights. The business world has moved on since 1999 and there is now an alternative business structure, the limited liability partnership (LLP), which combines some of the flexibility of a partnership structure but with limited liability. We question whether the new relief takes proper account of these developments and, in particular, whether the old retirement relief restrictions on personal holding companies are still appropriate given the advent of LLPs as an alternative business structure.
- 4 The legislation reintroduces the 'whole or part of the business' test that was such a problem for retirement relief for unincorporated businesses. This contrasts with the position for shares and securities, where it seems that any disposal, however small, can qualify. Further, on one reading of the legislation, it would appear that a partner can qualify for entrepreneurs' relief, however small the disposal of his interest in the partnership. If this understanding of this provision is correct, it would appear that this particular problem would then apply only to sole traders. We would welcome clarification of this point and whether this is the consequence of the provisions. If only sole traders are affected, it appears harsh and we request that the policy is reconsidered.
- 5 The new entrepreneurs' relief will be a very useful and valuable relief for gains up to the £1m limit. We recognise that the £1m limit is a policy decision and understand the rationale for it. However, given that the new relief is aimed at entrepreneurs rather than business people looking to retire, we are concerned that the £1m limit will not necessarily encourage 'serial' entrepreneurs to reinvest in new businesses.
- 6 We think that the limit should be indexed in line with inflation and to simplify matters there would be some logic in aligning it with the pensions lifetime limit. The limit should in any event be kept under review to see whether it discourages investment by serial entrepreneurs.
- 7 Suggested amendments

In Clause 2, Schedule 3, page 124, line 5, replace "£1 million" with "the entrepreneurs relief limit".

In Clause 2, Schedule 3, page 124, line 7, replace "£1 million" with "the entrepreneurs relief limit".

At end of Schedule 2, clause 2, insert

169T Entrepreneurs relief limit

The entrepreneurs relief limit will be £1million.

169U Indexation of the entrepreneurs limit

(1) This section applies if the retail prices index for the September before the start of a tax year is higher than it was for the previous September.

(2) The entrepreneurs relief limit for the tax year is the amount found as follows.

Step 1

Increase the entrepreneurs relief limit for the previous tax year by the same percentage as the percentage increase in the retail prices index.

Step 2

If the result of Step 1 is a multiple of £10, it is the starting rate limit for the tax year.

If the result of Step 1 is not a multiple of £10, round it up to the nearest amount which is a multiple of £10.

That amount is the entrepreneurs relief limit for the tax year."

Detailed comments on Schedule 3

Length of ownership- section 169I (Volume 1, pgs 120 and 121)

8 We welcome the 12 month ownership period set out in s 169I, which compares favourably with the ten year ownership period for retirement relief. Nevertheless, rather than reintroduce this definition, we believe it would make more sense and provide a further simplification if the definition that is used is the same as that used for the substantial shareholding exemption. This allows for any 12 month period within the previous 24 months. This change would mean that there was one common definition and would allow slightly more flexibility to a taxpayer who is in the process of extracting himself from a business.

9 Suggested amendments:

This should be consistent with paragraph 7 at Schedule 7AC.

Section 169I(3) line 26, delete the words 'throughout the period of 1 year ending with the date of the disposal' and insert in their place 'a 12-month period beginning not more than two years before the day on which the disposal takes place'.

Section 169I(4) line 30, delete the words ' throughout the period of 1 year ending with the date on which the business ceases to be carried on' and insert in their place 'a 12-month period beginning not more than two years before the day on which the disposal takes place'.

Section 169I(6) line 37, delete the words 'throughout the period of 1 year ending with the date of the disposal' and insert in their place 'a 12-month period beginning not more than two years before the day on which the disposal takes place'.

Section 169I(7) line 2, delete the words 'throughout the period of 1 year ending with the date of the disposal' and insert in their place 'a 12-month period beginning not more than two years before the day on which the disposal takes place'.

Associated Disposals- section 169K (Vol. 1, pg 122) & section 169P (Vol. 1 pg 125)

- 10 The legislation in respect of associated disposals in s169K and s169P is poorly drafted and needs to be clarified.
- 11 Section 169K lays down three conditions, of which condition A is that there is a main disposal qualifying for Entrepreneurs' Relief and condition C is that the property has been in use for the purpose of the business for a 12 month period. However, Condition B is loosely drafted and refers to the associated disposal being 'part of the withdrawal of the individual from participation in the business carried on by the partnership or by the company'. **It is not entirely clear what this relates to and it seems to be a retirement requirement of sorts, as well as conflicting with the main drafting of the requirements for a disposal. Its meaning should be clarified.**
- 12 Suggested amendments.
- That s 169K(3) and s 169K(5) are deleted.
- These deletions will require consequential amendments to the rest of s 169K
- 13 Section 169P is meant to deal with the restriction of the relief where the associated asset is not used entirely for the purposes of the business throughout the period of the ownership, or only partly used, or more controversially where the relief is based on the payment of rent. However, it suffers from a number of problems, further details of which are set out below.
- 14 The first point is that there is no start date in terms of the period of ownership. A logical start date would be 6 April 2008, but at the moment, but the wording seems to go back to when the asset would have been first acquired. On the grounds of simplification and consistency, we would have thought that these conditions should be applied by reference to the time period in s 169K(4), although we appreciate that in policy terms this may be too short a period.
- 15 The rules will operate to deny relief in circumstances where we think it should be available. The point is best illustrated by using an example which was set out in a document which was published on Budget Day providing examples of how the new relief would work in practice.

Example

Mr R has been a member of a trading partnership for several years. He leaves the partnership and disposes of his interest in partnership assets to the other partners, realising gains of £125,000, all of which qualify for entrepreneurs' relief. He also sells the partnership office building which he owned outright, but let to the partnership, realising a gain of £37,000. The disposal of the office building is "associated" with Mr R's withdrawal from the partnership business, and the £37,000 gain therefore also qualifies for entrepreneurs' relief (assuming there is no restriction on the amount of the gain qualifying for relief as a result of non-qualifying use).

- 16 Our understanding of the rules is that entrepreneurs' relief will only be available in relation to the office building if it was let 'rent-free' to the partnership for the whole of the period of ownership. We presume that the words in brackets at the end of the example are referring to this potential problem although the precise meaning of them is not clear.
- 17 The problem is that even if rental arrangements are changed from 6 April 2008 and any property is let rent-free, the test of whether the asset was an investment is by reference to the complete period of ownership, which will include any period of ownership prior to 6 April 2008.

The Tax Faculty of the Institute of Chartered Accountants in England and Wales

TAXREP 30/08

Finance Bill 2008: Clause 7 and Schedule 3, Entrepreneurs' relief

- 18 It therefore seems to us that the requirement to include the period of ownership prior to 6 April 2008 will restrict the availability of relief even if the taxpayer seeks to amend the position for the future. We appreciate that this provision is subject to a 'just and reasonable' test (s 169P(5)) but we believe that the period of ownership prior to 6 April 2008 should not be taken into account for these purposes.
- 19 The entrepreneurs' relief provisions covering associated disposals of assets should be amended to ensure that a retiring partner disposing of property that was let to a partnership before 6 April 2008 are not disadvantaged. As a minimum we think that in applying new s169L(4), periods of ownership prior to 6 April 2008 should be ignored.
- 20 Draft section 169P(4) reads as follows: -

The conditions referred to in sub section (1) are –

*a) that the assets which (or interest in which) are disposed of, are in use for the purposes of the business **for only part of the period in which they are in the ownership of the individual**;*

*b) that only part of the assets which (or interests in which) are disposed of, are in use for the purposes of the business **for that period**;*

c) that the individual is concerned in carrying on the business (whether personally, as a member of a partnership or as an officer or employee of a company which is the individual's personal company) for only part of the period in which the assets which (or interests in which) are disposed of are in use for the purposes of the business, and;

d) that, for the whole or any part of the period for which the assets which (or interest in which) are disposed of, are in use for the purposes of the business, their availability is dependent upon the payment of rent."

- 21 Sub Paragraphs (a) and (b) are defined both by reference to the period of the usage of the asset in the business and by the period of ownership by the individual. We have marked the references to ownership by the individual in bold. However, sub Paragraphs (c) and (d) include no reference to the ownership period by the individual and are only defined by reference to the usage of the asset in the business. Therefore, if we take an example of a farming partnership where the farmland is owned outside of the partnership and where the business is long established, then it would seem to follow that a partner is restricted to his period of ownership of the asset out of the total period of existence of the business even where the asset has always been in business use.
- 22 Whilst we appreciate that section 169P operates by reference to a just and reasonable apportionment and there are further clarifications in sub section 5, these do not appear sufficient to overcome the poor drafting. This section has been taken from Paragraph 10 of Schedule 6 TCGA 1992 but seems to have been reworded to an extent that is detrimental.
- 23 Suggested amendment

In order to clarify the legislation and provide certainty to taxpayers we recommend the following amendment.

Schedule 3, section 169P, sub section (4) delete lines 1 to 7 and insert:

'the conditions referred to in sub section (1) are that during the period of ownership of the individual or from 6 April 2008 if later –

a) that the assets which (or interests in which) are disposed of have not been in use for the purposes of the business throughout that entire period,

b) that only part of the assets which (or interest in which) are disposed of are in use for the purposes of business'

S169L(4) should be amended to read "In respect of qualifying business disposals within s169H(2)(a) and s169H(2)(b) the following are excluded assets – “.

Guidance on just and reasonable

- 24 There needs to be guidance on how HMRC will approach the 'just and reasonable' amount of disapplication of the gain from entrepreneurs' relief in all of the circumstances covered in s 169P(4).

Personal company definition

- 25 For the reasons explained above, we are concerned about the potential favouring of certain business structures and the way in which limited companies are potentially disadvantaged.

- 26 Suggested amendment

That s169I(6)(a) should be amended as follows – “the company is unlisted and is either a trading company or the holding company of the trading group, or” and that s169S(3) be deleted.

- 27 This would put limited companies on the same footing as LLPs and would also enable all employees to qualify for entrepreneurs' relief.

- 28 The personal company definition in draft s 169S(3) is different to that used for hold-over relief in s165(8) and for roll-over relief in s157. If it is to be retained then we cannot see the policy justification for this and would welcome clarification. Why is the tighter definition required for Entrepreneurs' Relief? Given that the Government is seeking to simplify CGT, we request that consideration is given to adopting the same definition throughout.

- 29 We are particularly concerned that the entrepreneurs' relief legislation as drafted will have a detrimental impact on EMI option holders and are concerned that this reflects the change of view by the Government against supporting such initiatives. We believe that EMI option holders who continue to qualify for this new relief from the date that the option is granted was the position for taper relief.

- 30 Suggested amendment:

- Paragraph 15 Sch 7D be amended to read “for the purposes of claiming entrepreneurs' relief on a disposal of qualifying shares, then in applying s169I and s169S(3), the shares are treated as if they had been acquired when the original option was granted”.

Section 169J

- 31 In relation to disposals by trustees, it is necessary for the company to be the qualifying beneficiary's personal company, ie the beneficiary needs to own 5% or more of the company. This seems unduly restrictive given that the beneficiary may not own shares personally in the company. We think that the provision should be amended and that the condition is by reference to the shares owned by the trustees.

- 32 We would welcome clarification that an interest in possession otherwise than for a fixed term does not therefore include a defeasible life interest.

Further information

33 Please do contact the ICAEW if you require any further information:

Frank Haskew
Head of Tax Faculty
Tel: +44 (0)20 7920 8618
frank.haskew@icaew.com

Liz Stevenson
Public Affairs Manager
Tel: +44 (0)20 7920 8694
liz.stevenson@icaew.com