TAXREP 36/15
(ICAEW REPRESENTATION
98/15)

FINANCE ACT 2015 ENTREPRENEURS' RELIEF CHANGES

ICAEW takes the opportunity to comment on the changes to entrepreneurs' relief introduced by Finance Act 2015.

This response of 7 July 2015 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

Contents

The Institute of Chartered Accountants in England and Wales
Chartered Accountants' Hall
Moorgate Place London EC2R 6EA UK
icaew.com/taxfac

T +44 (0)20 7920 8646
F +44 (0)20 7920 0547
E taxfac@icaew.com

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 144,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

For more information, please contact ICAEW Tax Faculty: taxfac@icaew.com

icaew.com

INTRODUCTION

1. The changes to entrepreneurs' relief (ER) introduced by Finance Act 2015 (FA 2015) were intended to be focussed anti avoidance provisions designed to end tax planning arrangements which HM Revenue & Customs (HMRC) considered to be unacceptable.

2. The provisions as enacted are more widespread than we understood to have been the policy intent and they are hampering normal business transfer arrangements which are not tax motivated and so are stifling growth. This is contrary to government policy.

3. Specifically we are concerned about the changes made in relation to:

3.1 the restriction on the availability of ER for retiring partners where they are associated with one of the participators or have retained a minority interest in the successor company

3.2 the restriction on the availability of ER for retiring sole traders where they are associated with a participator in a purchasing company

3.3 the deductibility of amortisation where goodwill and other assets are acquired from a related party

3.4 the removal of the joint venture company ('JVC') rules, which allowed for an appropriate proportion of the activities of a qualifying JVC to be included in determining the trading status of a company or group

3.5 the introduction of a restriction applying to corporate members in a partnership arrangement

3.6 the introduction of a minimum 5% holding in a partnership, company ordinary share capital or securities of a company in the case of a qualifying associated disposal.

4. This representation examines each of the above issues which we think are problematic and require change. We have also included some examples identified by our members from their own client base. The purpose of this document is to highlight the issues for our members and to hopefully form the basis for discussion with HMRC.

SPECIFIC MATTERS

Entrepreneurs' relief for retiring partners and on arm's length sales

Retiring partners

5. Following representations on the original draft legislation restricting the availability of ER on the incorporation of a company, there is now provision for retiring partners to claim entrepreneur's relief under s42, FA 2015. This is provided they do not become a member of the company into which the business is incorporated and there are no arrangements in place for that to happen.

6. In addition, s169LA(3)(b) and (c), TCGA 1992 also introduces a requirement that the retiring partner may be a related party in relation to the company, but only by virtue of being a business partner of a participator in the company. Essentially, this means that a retiring partner cannot claim entrepreneur's relief if, for example, they are a familial relative of a participator in the company with whom they have been in partnership.

7. An obvious example would be a father and son in partnership, with the son incorporating the business and the father retiring. In this scenario the goodwill would fall to be an excluded asset and ER will not be available on the associated gain.

Retiring sole traders

8. Similarly, if father were a sole trader and son decided to buy the business from him by setting up a BidCo, the father would not qualify for ER on the disposal of his goodwill. This would be the case even if he were not going to become a participator in the company, as the father fails to satisfy the requirement in s169LA(3) as he will be a related party by virtue of his relationship to his son.

9. We can see no policy reason for such restrictions as described above on a genuine retirement. Indeed, it was clear from the December 2014 announcements that the target was tax advantaged incorporations with no real change of economic ownership. Instead, this restriction merely prevents a business transfer arrangement which is a common means of continuing a family business.

10. The solution would be to review s169LA(3). It is not clear why there is a requirement that the retiring person has to be a partner immediately before the disposal and the purpose of s169LA(3)(b) and (c) is also not clear. The stated policy aim of the legislation is met by ensuring that ER is only available if the retiring partner is not going to be a participator in the successor company.

Retaining a small stake on retirement

11. A fundamental unfairness introduced by s42, FA 2015 is that a person would not be able to claim ER on the disposal of the goodwill if they were to sell their business on arm's-length terms to an independently owned company where there is the intention for the trader to become a minority shareholder.

12. This scenario might arise for any number of sensible commercial reasons, such as ensuring a smooth integration of the acquired trade into the business of the purchasing company. This sometimes occurs because it ensures a continuing relationship with existing suppliers or customers, or because people want to keep a small stake for sentimental reasons. This is recognised in, for example, HMRC's acceptance of such post-retirement shareholdings in the Company Purchase of Own Shares rules. Not only is this restriction in the context of selling a business to a company unfair, but it is also inconsistent with other provisions.

13. The implications introduced by s169LA, TCGA 1992 are perceived to be particularly unfair if the trader(s) has qualified for ER on a sale, but the goodwill element failed to qualify as a result of his participation in the purchasing company.

14. In effect, the legislation takes away their right to 'bank' the entrepreneur's relief when they sell to a larger concern, where they will not qualify on exit.

15. A suggested solution to this issue would be to provide that ER could be available in such circumstances, so long as the shareholding that the sole trader or partners obtain in the successor company is less than, say, 10% (to give some head room in case of future share issues that would dilute the holdings). This test might be made subject to this also being a material reduction in their level of ownership of the trade (so the relief does not remain available to a 10% partner on incorporation).

The amortisation of goodwill where it is acquired from a connected party

16. We acknowledge the premise that incorporation of a business into a company under the same ownership, allowing access to amortisation deductions for goodwill, was a generous relief. However, in some cases the new legislation gives an unfair result with regards to the amortisation of goodwill.

17. On a genuine third party acquisition of a partnership or sole trader business by a company, as outlined above, the vendor business owner may be required to take a small stake in the purchasing company as part of the commercial transaction. Not only is the vendor disadvantaged (as noted above), but the company is also disadvantaged. The provisions in s26, FA 2015, mean the company is denied trading debits under s729, Corporation Tax Act 2009 (CTA 2009) on what is, as far as it is concerned, a third party acquisition with no abusive intent and, indeed, no abuse.

18. This is unreasonable as the successor company has identified a commercial transaction and decided the value of the transaction would be enhanced by having the original business owner on board for a period of time, but the company cannot then claim tax deductions for the amortisation of the goodwill or similar assets.

19. This is not helpful to business, as the company is being given a choice between a tax deduction for an arm's length acquisition of goodwill, or enhancing the value of the transaction by incentivising the original business owner with some shares in the company, in which case it is no longer entitled to the goodwill deductions.

20. This disadvantage would be removed if some level of shareholding by the original shareholder or shareholders was set below which the reliefs would still be available. A figure of 10% is suggested above and there is some logic in matching the maximum holding to permit the vendor to claim ER, with the maximum holding that still permits the company to claim tax deductions for goodwill acquired in an arm's-length transaction. A figure of up to 25% (in both cases) would be more helpful and commercially more sensible.

Joint venture companies

21. The changes made to the JVC rules at s165A, TCGA 1992 (7) and (12), which allowed for an appropriate proportion of the activities of a qualifying JVC to be included in determining the trading status of a company or group are problematic.

22. We note the intention of s43 is to deny ER to those holding less than 5% of a company's ordinary share capital and voting rights, without also holding equivalent economic rights in the underlying trading business.

23. While we understand the aim of the legislation, the provisions have been drafted in a way which means that entirely commercial and historic group structures are caught as an unintended consequence of the new legislation. It would seem that the wider ER impact is unintended as the new rules do not impact the trading status of a group for Substantial Shareholding Exemption purposes.

24. The rules stipulating the inclusion of an appropriate proportion of a JVC trade in the determination of a company's or group's trading status are removed by s43, FA 2015. As a result, any company that carries out its trade through a JVC ceased to qualify for ER, even when in the vast majority of cases there is no abuse of the rules, ie, where the shareholders' underlying interest in the trading company is at least 5%.

25. A straightforward solution to the issue would be to allow ER only where there is at least a 5% direct or indirect holding.

26. The effect appears to be that a holding of ordinary shares that is insufficient to achieve a 51% subsidiary relationship may now be classified as an investment, ie, a non-trading asset in determining the trading status. As such this might impact the availability of ER.

27. We also note that the exact treatment of the JVC has been left silent in the legislation as s165A, TCGA 1992 (7) and (12) have simply been disregarded. This is ambiguous and some clarification around this area would be appreciated in any event, perhaps along the lines of Revenue & Customs Brief 29/11.

Corporate members of a partnership

28. The rules for corporate partnerships also go further than we believe were intended. Again, we note the intention of s43 is to deny ER for those holding a 5% share in the company's ordinary share capital and voting rights, who do not also hold equivalent economic rights in the underlying trading business of the partnership. Once again, the provisions have been drafted in a broad sense which means fully commercial and historic structures are caught as an unintended consequence of the new legislation.

29. The restriction in relation to a shareholdings in a company, which is in turn a corporate member of a partnership, is introduced under s169S(4A)(b), TCGA 1992 and provides that the activities of the partnership are to be treated as not being trading activities. This means shareholdings in genuine commercial corporate partnerships may no longer qualify for ER, even where the interest in the underlying trade is at least 5%.

30. A straightforward solution to the issue, as above, is to allow ER only where there is at least a 5% direct or indirect holding.

31. It is not uncommon for corporate entities to be used as a means for shareholders to limit their risk when involved in a partnership and so the current limitation hinders a sensible business practice.

Associated disposals

32. We also envisage issues for associated disposals as a result of the drafting of this legislation.

33. Section s41, FA 2015 amends s169K, TCGA 1992 to require that where an asset is used for the purposes of trade, but is held outside a partnership or a company, the associated disposal of that asset will not qualify for ER unless there is a corresponding disposal of at least a 5% share in the partnership, ordinary share capital or securities of a trading company. This is as set out in conditions A1, A2 and A3.

34. It is possible for a material disposal of a business to take place where that share of the business is relatively small. This may be the case where a business is owned and run by several generations, as a result of older generations retiring and handing over the business to their brothers, sisters, children and remoter issue over a period of time. It is unfair in this situation, if as part of the retiring business owner's withdrawal he or she also disposes of the property in which the trade is carried on and the gain realised does not qualify for ER as the owner's stake in the business has now diminished to less than 5%. In contrast had the property been held by the business the gain would qualify for ER.

35. This scenario is not uncommon in the agricultural sector where the farming business is often family run and held over a number of generations.

36. We propose that s169K, TCGA 1992 is amended to include a provision such that where the individual is disposing of a share of less than 5%, provided that disposal amounts to the whole of his retained interest, the associated disposal will qualify for ER.

Conclusion

37. In view of the unintended consequences of the changes in legislation, as highlighted by the examples below and scenarios discussed above, we would be happy to discuss with HMRC how the rules can be changed to minimise or eliminate the number of genuine commercial structures adversely affected by the changes.

38. The legislation as currently drafted offers no distinction between an artificial structure that has been set up to purposefully access ER relief and those which are genuine commercial arrangements where relief should remain available. As such careful consideration and detailed consultation should be given to future adaptations or appeals.

EXAMPLES

39. In a group situation to avoid being "caught" by the change in legislation two LLPs regulated under the Financial Conduct Authority (FCA) have to incorporate which will be done by transferring the trades and assets to two new companies. In this case, the transfers seem relatively straightforward provided the FCA will allow a speedy transfer of authorisation but it is not clear how moving a regulated business from an LLP essentially wholly owned by a company to a new subsidiary of that same company has made matters any better from an HMRC perspective.

40. A client was advised to own his share (49%) of a US "S corp" to mitigate the potential effect of mismatched profits/income in the US and UK, ie a double income tax charge without any relief. If the new rules are enacted as planned, it is quite possible that he will not benefit from entrepreneurs' relief, whereas direct ownership, with the attendant unfairness in his ongoing income tax liability here and in the USA, would probably allow him to claim the relief.

41. Similarly an investment into a US LLC via a company to avoid income tax mismatch will result in the loss of ER.

42. A company has been used as a single entity investment vehicle by a group of individuals to avoid issues on multiple shareholders. The majority of holdings are around 25% and ER was available but is lost under the new provisions.

43. Mr and Mrs A set up A Limited to enter into a 50/50 JVC with an unconnected listed company to exploit the talents of Mr and Mrs A. They formed a JVC, X Limited owned 50% by A Limited and 50% by the listed company. The listed company subsequently decided that if the JVC was to continue they wanted a larger share. This was achieved by their acquiring 50% of A Limited. Accordingly Mr and Mrs A now indirectly own 25% of X Limited (50% of 50%), so logically ought to be entitled to ER. However they no longer qualify. A Limited is not itself a trading company and, as it owns exactly 50% of X Limited, it is not the holding company of a trading group.

This problem has potentially been solved by A Limited acquiring the listed company's shares in X Limited by means of a share exchange. That makes A Limited the holding company of a trading group. However it obviously took a few weeks to achieve that. In that period Mr and Mrs A ceased to qualify, so have to start a new 12 month period. This is inconvenient to everyone as the listed company would now like to own 100% of X Limited but Mr and Mrs A are not prepared to sell their shares until the 12 month period is up. That potentially damages the UK economy as the listed company will not expand the business of X Limited until it becomes a 100% subsidiary.

44. Potentially thousands of family partnerships are caught by the flawed definition of a retiring partner.

45. We have an LLP which just has two limited companies as members. Both companies (one owned equally by two shareholders, the other owned equally by three shareholders) were house building companies which traded in their own right for many years. About a decade ago they wanted to pool their resources so formed the LLP and all the trade was done in the LLP from that point, each company simply receiving its share of the LLP profit. The shareholders in the two companies appear to be denied ER under the new rules.

46. An LLP with eight individuals as members plus a corporate member which is owned by the eight individual members. Shareholders exiting the corporate partner, on the basis it has no trade of its own, will be denied ER.

47. A 50/50 venture between a company and a Council within an LLP – the company is barred from being classed as trading when the LLP is carrying on a development activity. The Council insist commercially on an LLP and not a company so the group which has this structure no longer qualifies.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see via http://www.icaew.com/en/about-icaew/what-we-do/technical-releases/tax).