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Entrepreneur's Relief and Business Property Relief

Below is a summary of the rules regarding maintaining "trading" status for both Entrepreneur's Relief for capital gains tax (CGT) and Business Property Relief for Inheritance Tax (IHT).

1. **Entrepreneur's Relief (ER)**
If you are eligible for entrepreneur's relief, certain qualifying chargeable gains during your lifetime up to £10M can be taxed at just 10% rather than 18% or 28%. The tax saving could be substantial and it is important to ensure you meet the qualifying conditions.

   The conditions for getting ER on a disposal of shares or a winding up of a company are:

   a) You must be an officer or employee of the company for two years before the sale (one year for sales before 6 April 2019);

   b) You must hold at least 5% of the company's ordinary share capital, of voting rights and of the right to assets on a winding up or sale, again for at least 2 years prior to the sale. This 5% test is looked by nominal value, not simply on the number of shares – this is relevant if say there is a mixture of £1 and £0.01 shares; and

   c) The company must be a trading company for two years before the sale (for sales after 6 April 2019 – previously just one year). A trading company is "a company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities" (TCGA1992, s169S(5) as read with s165A).

      It is thus possible for a company which contains excessive investments making it a non-trading company to divest itself of those non-trading investments/activities and possibly re-acquire trading status at least one year before a share disposal.

      HMRC's view on the meaning of "substantial" is set out at CG64090 (see this link http://www.hmrc.gov.uk/manuals/cgmanual/CG64090.htm).

      In essence, HMRC's view is that provided the non-trading activities do not exceed 20%, the company remains trading and ER is preserved. This 20% rule is not based in statute – it is simply HMRC's view. The "rule" has never been tested in the courts. We know from previous case law that sometimes a case can overturn HMRC's guidance, making it redundant. However, as we currently having nothing better to go on, we have to ask 20% of what?

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The HMRC manual at CG64090 says that HMRC will consider whether 20% has been exceeded in four separate categories:

(i) The **income** from the non-trading activity as a percentage of the total income;

(ii) The value of the "investments" as a proportion of the total **net assets** as shown by the Balance Sheet of the company. Note that Goodwill is often not shown at market value on a company's balance sheet. HMRC permits Goodwill to be notionally re-valued on a balance sheet which helps to keep the percentage relating to investments down;

(iii) **Expenses** incurred and the amount **time spent** in connection with the non-trading activities;

(iv) The **history** of the company. This means a view needs to be taken over a longer period of time thus eliminating distortions from the seasonal nature of a business or fluctuations in fortune.

It should be stressed that it is the overall picture of the business as a whole that needs to be considered not any one specific test in isolation.

What does this mean in practice?

Many trading companies build up cash balances from profits which over a period of time can become "excessive" to trading requirements

Provided excess cash plus other non-trading activities/assets does not exceed 20% of the total assets, there should be no problem.

HMRC has always taken the view that the holding of excess cash is itself a non-trading activity but this has never been tested in the courts. Where the cash is managed, for example by using money market accounts, the holding of excess case may be treated as a non-trading activity. However, where it is simply held on current account, this should not be a problem. Case law such as ***Jowett v O'Neil and Brennan Construction Ltd*** [1998] STC 482 in which cash held on deposit by a company was held not to be a business may be useful in defending an excess cash case.

It is only the excess cash that needs to be measured, not the total cash in the business. HMRC will normally accept that, for example, reasonable holdings of cash as part of working capital, or against contingencies, or to build up a reserve of cash to fund the future expansion of the trade, are part of the company's trading activities. Periodically high levels of cash are also acceptable where the company's business is seasonal in nature. However, difficulties can arise where cash is at a level that significantly exceeds the company's reasonable requirements. There is a balance to be struck between the attraction of accumulating cash to benefit from a 10% tax rate on eventual exit and the risk that the cash could be treated as non-trading so could prevent ER from applying.

It is important to build up a file of evidence to back up the reasons for holding cash and to document the plans for the cash. This includes copies of board minutes - HMRC places great reliance on board minutes, even for the smallest of family-run companies.

If you convert cash into say bonds, equities or rental properties with a view to earning a higher return on the monies, to preserve ER, you should seek to ensure again that the value is 20% or less of the assets of the company as a whole. Moreover, the assets should be shown as “Current” not “Fixed” on the Balance Sheet.

2. Business Property Relief (BPR)

BPR enables the assets to obtain 100% relief from IHT. In other words, if an asset qualifies for BPR, none of the value of the asset is subject to IHT on death.

The statutory position for BPR is somewhat different to ER. There is no positive requirement that a company needs to be ‘trading’. Instead the business must not consist ***wholly or mainly*** of one or more of the following:

- dealing in securities, stock or shares (subject to certain exemptions concerning ‘market makers’ and discount houses) (IHTA 1984 ss 105(4)(***a***) and 105(7));
- dealing in land or buildings; or
- making or holding investments (IHTA 1984 s 105(3)).

What needs to be established is that the company is ***not mainly*** an investment. For example, in the case of ***Phillips (Executors of Phillips, decd) v HMRC*** [2006] STC (SCD) 639 a company whose balance sheet consisted almost entirely of loan creditors qualified for relief because these were not considered to be investments even though, arguably, it might not have been possible to establish that the company was trading.

The other significant difference to ER is that the context of BPR and IHT is taken to mean more than 50%. It is thus easier for shares to qualify for BPR than for ER where there is the 80% trading hurdle.

How to apply the ***wholly or mainly*** test has been at the centre of many cases but the Special Commissioners' decision in ***Farmer (Executors of Farmer dec'd) v IRC*** [1999] STC (SCD) 321 consolidated what has become known as the ‘in the round’ approach where the Special Commissioner stated that it was necessary to consider five relevant factors:

- the overall context of the business;
- the capital employed;
- the time spent by the employees;
- the turnover; and
- the profit

and then to take the whole business in the round, ‘…and without giving predominance to any one factor’ consider whether it is mainly one of making or holding investments.

Where the wholly or mainly test is passed, the entire value of the business can attract 100% relief. In other words, there is no automatic apportionment of relief in relation to the investment element of the business.

Relief is however restricted/apportioned where there are ***excepted assets*** on the company's balance sheet. Excepted assets are assets which are neither used wholly or mainly for the purposes of the business during the previous two years or, if it has not been owned for two years, its entire period of ownership; nor required at the time of the transfer for the future use of the business (IHTA 1984 s 112(2)).

The asset most commonly identified as an excepted asset by HMRC is surplus cash.

HMRC often uses the case of ***Barclays Bank Trust Co Ltd v IRC*** [1998] STC (SCD) 125 as authority for a restriction of BPR on the basis that cash is an excepted asset. In that case, the executors failed in their argument that surplus cash within the business – which had in fact been used some seven years after the date of death to acquire an unrelated business – was at the date of death required for the future use of that business.

As a result, where a company holds more than working cash and where there are no definite future plans for the use of the excess, BPR might be restricted regardless of the relative value of the excess cash to the whole business. The position here can be contrasted with that for ER where excess cash of up to 20% of the value of the business would not restrict the relief.

Example: Entrepreneurs' relief

John owns all the shares in A Ltd which has been trading as IT consultants since 2003. The goodwill value is considered to be £900k. He is considering a gift of 10% of the shares to his nephew. The current balance sheet shows the following:

	£'000
Freehold trading property (current value)	250
Plant and machinery	125
Debtors less creditors	(5)
Cash on deposit (considered to be excess)	200
	570

In the Example, the cash held on deposit would be treated as an excepted asset and would lead to a BPR restriction. If the cash were, however, used to buy stocks and shares, BPR might not be restricted, assuming they represent part of the company's business which meets the wholly/mainly test.

If you have no intention as shareholder/director of disposing of your shares but are seeking the best possible structure to minimise IHT on death, then keeping investment assets within the company, assuming this does not breach the wholly or mainly test for BPR, may be the ideal structure. Conversely where a clear exit strategy is in point, the attraction of a 10% tax rate will mean you need to consider the best structure to help preserve ER.

Where investment and trading activity is carried on within one company, a separation of the activities by way of a non-statutory demerger could be considered - this would improve the ER position. However, it may have adverse consequences from an IHT

perspective where as a result shares are held in a pure investment company. In carrying out any structuring work on private companies all the reliefs should be considered to ensure that there are no unintended results.

Thus you may need to consider the overall objective and future plans for the company in deciding whether to preserve one relief at the expense of the other.

For this reason, some people wish to deliberately keep some investments in the balance sheet with a view to shielding these from IHT. The danger though is that by so doing, you may inadvertently jeopardise ER.

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