



This briefing explains the capital gains treatment of family business disposals following the significant changes introduced from 6 April 2008. It focuses mainly on the availability of Entrepreneurs' Relief in a range of scenarios and the conditions required for maximising the available tax savings.

## Family business disposals - the new tax position

### The new CGT position compared

From 6 April 2008 the calculation of a capital gain for an individual mainly consists of sales proceeds less a deduction for capital costs of acquisition. The allowance for inflation, known as indexation allowance and also taper relief are no longer available. An annual exemption is still available for each individual to reduce chargeable gains. This is £9,600 for 2008/09 but will be ignored for the purposes of illustrations throughout this briefing. All remaining gains are then charged at the new flat rate of 18%.

This is good news if you have gains on what were previously referred to as non business assets which incurred a tax rate of between 24 - 40% after taper relief for a higher rate taxpayer. However, it is not generally beneficial for gains relating to disposals of assets or shares of a family business.

Up to 5 April 2008 such gains benefited from both indexation allowance, if held between March 1982 and April 1998, and up to a 75% reduction in the gain due to business taper relief. For higher rate taxpayers the impact of business taper relief alone reduced the capital gains tax bill to an effective 10% rate as follows:

#### 2007/08

William, a higher rate tax payer sold his 60% shareholding in Shakes Limited, a trading company realising a chargeable gain of £500,000 on 31 March 2008. On the basis that the gain fully qualified for business taper relief then only £125,000 of the gain was chargeable @ 40% = £50,000 tax. This is an effective 10% higher rate of tax.

#### 2008/09

If the transaction had been delayed to 30 April 2008 a gain of £500,000 would suffer an 18% charge of £90,000 a £40,000 increase!

### A new relief.....?

After business leaders voiced their objections to the impact of the changes on business gains, the Chancellor introduced a new Entrepreneurs' Relief (ER). ER may be available for business disposals and other relevant transactions taking place on or after 6 April 2008.

The main effects of this relief are that:

- an individual will be able to make claims (more than one if relevant) for ER, up to a lifetime total of £1m of gains;

- the first £1m of gains qualifying for relief will be charged at an effective rate of 10%; but
- gains in excess of £1m will be charged at 18%.

#### ER - impact

The effect of the relief is to reduce eligible gains liable to CGT at 18% by 4/9ths on the first £1m, resulting in an effective rate of 10% (18% x 5/9ths).

In William's case above if the gain of £500,000 qualifies for ER then a reduction of 4/9ths leaves £277,778 @ 18% = £50,000.

### Which disposals qualify for relief?

There are four situations in which a disposal of business assets by an individual may qualify for relief:

- a disposal of whole or part of a business;
- a subsequent disposal of assets in use in the business at the time of the cessation of the business;
- a disposal of shares in or securities of a company; and
- a qualifying associated disposal.

In addition, certain disposals by trustees may qualify but due to the special conditions which apply, this is not considered further in this briefing. Do contact us if this may be relevant to you.

### What is a business?

A business means a sole trader or partnership trading business. Professions and vocations are also included in the term trade. A property business is only included if it is a 'furnished holiday lettings' business.

### A qualifying business disposal

ER applies to the gains on the disposal of either the whole or a distinct part of a trading business.

The individual must have owned the business or partnership interest for one complete year up to the date of a disposal.

### Be careful

The disposal of a property used in the trading business will not qualify if it is not considered to relate to the disposal of the whole, or part, of the business.

For example, the sale of some land by a farmer would not qualify for relief as neither the whole, nor a part, of a business has been sold. Rather, it is a business asset only that has been sold.

This rule is considered to apply whether the business is operated as a sole trader or through a partnership and can be tricky so please contact us for further advice on this area.

What is acceptable as a disposal of a part interest is where a partner reduces his overall interest/share in the business say from 45% to 30% or when an existing sole trader forms a partnership.

### Is there an alternative relief?

If a trading property is sold in a situation where a replacement trading asset is acquired within a qualifying time period then the gain may be deferred using another relief known as rollover relief. Although deferring a gain is not as beneficial as exempting part of a gain, it is useful in a situation where a chargeable trading asset is sold because the business wants to expand into larger premises or relocate. The gain will then subsequently be chargeable on the disposal of the replacement asset in the future.

### Ceasing to trade?

Where a sole trader or partnership ceases to trade and sells off the assets used in that trade then ER will be available provided that:

- the assets were used in the trade and the business was owned by the individual for 12 months up to the cessation of the trade; and
- the assets are disposed of within three years of cessation.

Similar provisions apply where a company ceases to trade, sells the assets and capital distributions are made to the shareholders.

### What about share disposals?

The relief will apply to gains on disposals of shares (and securities) in a trading company (or the holding company of a trading group) provided that the individual making the disposal:

- has been an officer or employee of the company, or of a company in the same group of companies; AND
- owns at least 5% of the ordinary share capital and that holding enables the individual to exercise at least 5% of the voting rights in that company

throughout the year leading up to the disposal of the shares.

The relief is not available where the company is classed as a non trading company.

### Point to watch

If your trading company has used surplus funds to invest in non trading assets, such as an investment property, it may be deemed to have substantial non trading activity if the asset value or the income exceeds what is known as the 20% threshold. Contact us for further guidance on this aspect.

### Planning for share sales

Provided that each individual meets the basic requirements above, they can have further shares added to their holding and those shares will qualify for ER even if not held for a complete year. Where shareholders are spouses or registered civil partners, some last minute planning may enable a better ER position to be obtained so please contact us if this affects you.

### What about commercial property?

Due to changes in business asset taper relief rules, commercial property, in recent years, owned by an individual but used by any trade (even where rent charged) enjoyed the favourable business asset status. The availability of such a generous relief was not the only reason for keeping property ownership in the hands of an individual rather than in a company but was certainly a valuable one. Now such gains are primarily charged at 18%.

The introduction of ER does not do much to reduce the problem. The only situation in which ER is generally available on the disposal of commercial property is by means of an 'associated disposal'.

### What is an associated disposal?

The disposal of an asset may qualify for ER if:

- the individual makes a material disposal of either the whole or part of their interest in a partnership or shares in a company; and
- the associated disposal is made as part of the withdrawal of the individual from participation in the business of the partnership or the company.

The relief is aimed at situations where the person running the business holds an asset personally which is used by the business.

### Example

Richard Bull has run a company for a number of years and holds 55% of the shares. He has personally owned the premises from which the company trades. He sells the shares for a gain of £100,000 and the premises for a gain of £800,000. His son is to take over as managing director but he is going to continue as a director for a further year or so.

The gain on the shares qualifies as a material disposal for ER and he will obtain relief on that.

The disposal of the premises also qualifies because there has been a material disposal. It represents part of his withdrawal from the business and the premises have been used in the business. HMRC state that it is not necessary for him to withdraw from operational involvement although in many situations this will reduce over a period of time.

### Trap 1

If the purchaser wants to buy only the premises and not the shares, Richard will get no ER because there will not be a material disposal.

### Trap 2

In certain circumstances, even though the main conditions are met, the relief for the associated disposal may be restricted. These include situations where the:

- asset was used for business purposes for only part of period of the ownership by the individual
- asset was only partly used for business
- individual was only involved in the business for part of the time the asset was used.

In addition, if the availability of the asset depends on the payment of rent, for periods from 6 April 2008 onwards, then relief will only be allowed to the extent to which rent is less than market rate.

### Example

If Richard had let the premises to his company to trade from at a market value rent, since 6 April 2008, then no relief would be available on the premises when they were sold.

### Going forward

There are many businesses which use premises owned by the proprietor personally and for which a rent is charged. The rules only restrict ER where rent is paid from 6 April 2008 onwards, so consideration should be given to possibly stopping the rent.

If you feel that this situation may apply to yourself, please get in touch as soon as possible to discuss your options.

### Be careful

Considerable care will be needed in planning to obtain the benefit of ER. There are a number of traps for the unwary.

As ever, tax is not straightforward. If you would like to discuss ER in detail and how it might affect your business, please do get in touch.