

## TAXGUIDE 2/08

### CAPITAL GAINS TAX FOLLOWING THE 2007 PRE-BUDGET REPORT AND ENTREPRENEURS' RELIEF

*A guidance note published on 7 March 2008 by the ICAEW Tax Faculty on the implications of the proposed changes to capital gains tax announced in the 2007 Pre-Budget Report on 9 October 2007, as further amended by the proposed 'entrepreneurs' relief' announced on 24 January 2008. This guidance note updates TAXGUIDE 4/07 published on 2 November 2007.*

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ICAEW Tax Faculty, Chartered Accountants' Hall,  
PO Box 433, Moorgate Place, London EC2P 2BJ  
[www.icaew.com/taxfac](http://www.icaew.com/taxfac)

T +44 (0)20 7920 8646  
F +44 (0)20 7920 8780  
E [tdtf@icaew.com](mailto:tdtf@icaew.com)

# CAPITAL GAINS TAX FOLLOWING THE 2007 PRE-BUDGET REPORT AND ENTREPRENEURS' RELIEF

## INTRODUCTION

1. The aim of this guidance note is to update ICAEW members on the reform of capital gains tax (CGT) that was first announced in the 2007 Pre Budget Report. This note concentrates on 'entrepreneurs' relief', a new relief for disposals of business assets up to £1m which was announced on 24 January 2008. The note concludes with some planning suggestions to maximise the availability of existing reliefs before the start of the new regime on 6 April 2008.

## SUMMARY OF THE PROPOSED CHANGES

2. The Government announced in the Pre Budget Report on 9 October 2007 a major reform of capital gains tax (CGT). The reform will apply to individuals, trusts and personal representatives but not to companies who will continue to be taxed on gains according to the existing rules for companies. The proposal is that the taper relief rules, which were introduced in 1998, will be withdrawn and replaced with a flat rate of CGT of 18% which will take effect from 6 April 2008.
3. Any existing entitlement to indexation allowance will also be withdrawn. Where assets were held on 31 March 1982, there will be an automatic rebasing of those assets to their market value on 31 March 1982. Transitional rules brought in relating to March 1982 such as 'halving relief' and the 'kink test' are also to be abolished.
4. Unlike taper relief, under the new regime no special reliefs were planned for business assets or for holding assets for the longer term. However, following extensive lobbying by various bodies, including the ICAEW Tax Faculty, the Chancellor announced on 24 January 2008 that the new flat rate system would include an *entrepreneurs' relief*. The relief taxes gains from disposals of businesses at only 10% (rather than the proposed 18%) up to a lifetime cumulative limit of £1m. Draft legislation was published at the end of February 2008. The new relief is based broadly on the old *retirement relief* rules, which were phased out over a five-year period beginning in 1998.
5. Although the proposed reform is justified as a simplification, it is also a revenue raising measure. In the 2007 Pre Budget Report the Government said it is expected to raise £350 million in 2008/09, rising to £900 million in the following years, although the proposed entrepreneurs' relief will reduce the expected revenues. The reform (even as amended by entrepreneurs' relief) creates a significant number of winners and losers.

## START DATE

6. It is proposed that the new rules will apply for disposals of assets on or after 6 April 2008. Existing rules and CGT reliefs, including taper relief and any accrued indexation frozen at the time of the 1998 change, will continue to apply to disposals up to that date but not afterwards.

## EXISTING RELIEFS

7. Existing CGT reliefs such as the annual exemption, loss relief, principal private residence relief, gift hold-over relief for business assets, roll-over relief for business assets and various reliefs for Enterprise Investment Scheme (EIS) and Venture Capital Trust (VCT) investments will continue to be available.
8. While roll-over, hold-over and EIS CGT deferral relief will still be available after 5 April 2008, taper relief will be withdrawn. Where cash flow permits and taxpayers have built up significant taper relief, it may be more tax-efficient to make a disposal before 6 April 2008 and pay the tax due on the gain rather than make a claim for CGT deferral relief. This is because making a claim for deferral relief will result in the permanent loss of the beneficial taper relief that has been built up.

## ENTREPRENEURS' RELIEF

9. This relief was announced on 24 January 2008 and the draft legislation was published on 28 February 2008. It will apply for disposals taking place on or after 6 April 2008, ie from the start date of the new 18% flat rate of CGT.
10. Where the necessary conditions are met, entrepreneurs' relief will reduce the effective CGT rate on the gain from 18% to 10%. It achieves this by reducing the gain that would otherwise arise by 4/9ths, ie it reduces the 18% flat-rate to 10%.
11. Entrepreneurs' relief applies to gains of up to £1m. The £1m is a lifetime limit, so if any gains that qualify for entrepreneurs' relief are below the £1m limit, the excess will be available to reduce any future gains that qualify. However, no further relief is available if the cumulative gains exceed £1m, with the result that gains in excess of £1m are taxed at the standard 18% CGT rate rather than the 10% rate.
12. Entrepreneurs' relief is not automatic and must be claimed. A claim for entrepreneurs' relief in respect of a qualifying business disposal must be made on or before the first anniversary of the 31 January following the tax year in which the qualifying business disposal is made.
13. The legislation bears some similarities to the former retirement relief, which was phased out starting in 1999/00 following the introduction of taper relief. As such, entrepreneurs' relief is more restrictive than the current business taper regime.
14. HMRC published the following information on 28 February 2008 at [www.hmrc.gov.uk/cgt/index.htm](http://www.hmrc.gov.uk/cgt/index.htm):
  - [draft clauses](#);
  - [draft explanatory notes](#); and
  - [draft Frequently Asked Questions](#) (FAQs).

### Entrepreneurs' relief – main conditions

15. In relation to an *individual*, a disposal will qualify for the new entrepreneurs' relief if it is:

- (a) a disposal of the whole or part of a business owned by the individual throughout the period of one year ending with the date of the disposal; or
  - (b) a disposal of one or more assets in use at the time at which a business ceases to be carried on where:
    - the business is owned by the individual throughout the period of one year ending with the date on which the business ceases to be carried on; and
    - that date is within the period of three years ending with the date of the disposal; or
  - (c) a disposal of shares in or securities of a company, subject to the conditions set out in paragraph 18 below.
16. Note that in (a) above, the new relief follows the old retirement relief code that there has to be the disposal of the whole or part of a business. This contrasts with business asset taper relief which is available on the disposal of a business asset. The practical difference is that the disposal of a single business asset, for example a piece of farmland, may not satisfy the conditions for entrepreneurs' relief unless it is disposed of within three years of the business in which it was used ceasing and therefore comes within (b) above, as while it is the disposal of a business asset (which currently qualifies for business asset taper relief), it is not the disposal of a part of the business.
17. HMRC's entrepreneurs' relief FAQ 5 points to HMRC's *Capital Gains Manual* which discusses what constitutes the disposal of the whole or part of a business at paragraph CG63530 onwards – see [www.hmrc.gov.uk/manuals/cg4manual/CG63530.htm](http://www.hmrc.gov.uk/manuals/cg4manual/CG63530.htm). These paragraphs relate to the old retirement relief, but HMRC considers that the same principles will apply. Old case law relating to retirement relief is also likely to be relevant.
18. For a disposal of shares or securities, the key conditions which must be satisfied throughout the 12 months before the disposal are that:
- the shares must be held in a *trading company* or *holding company* of a trading group;
  - the shareholder must be an officer or employee of that company/fellow group company – there is no minimum hours requirement and an officer for these purposes will include the company secretary or a non-executive director; and
  - the shareholder must hold at least 5% of the ordinary share capital (carrying at least 5% of the voting rights). Unlike retirement relief the shares of a spouse are not added together for these purposes, but a taxpayer can count a proportionate share of a joint holding, so where there is a joint shareholding of 10% then the joint holders will each qualify for the new relief.
19. Most employee shareholders and many AIM investors will be unable to meet the conditions necessary to secure entrepreneurs' relief.
20. In relation to *trustees*, they will be able to claim entrepreneurs' relief on a disposal of trust assets where:

- (a) the trustees make a disposal of settlement business assets (broadly shares or business assets); and
- (b) there is a qualifying beneficiary who has an interest in possession (but excluding one for a fixed term) in the whole of the trust property or that part of it which includes the business assets being disposed of.

A claim to entrepreneurs' relief in relation to a disposal of trust assets has to be made jointly by the trustees and the qualifying beneficiary. The claim will count against the qualifying beneficiary's £1m lifetime allowance (see paragraph 11 above) – in other words the trust does not have its own allowance.

- 21. Where the trust assets are shares, the qualifying beneficiary must be an officer or employee of the company **and** the qualifying beneficiary must hold directly at least 5% of the shares. In addition, the company must be a trading company or the holding company of a trading group. Where the assets are business assets, the trust business assets must be used for the purposes of the business carried on by the qualifying beneficiary.
- 22. Relief is also available in limited circumstances for *associated disposals*, namely the disposal of assets use in a business but owned personally where they are disposed of as a result of the taxpayer withdrawing from participating in a company or partnership.

#### **Relevant business assets**

- 23. Where the assets being disposed of are not shares or securities, entrepreneurs' relief is only given in respect of a disposal of relevant business assets. These are assets used in the business but excluding shares, securities and assets held as investments. This contrasts with a disposal of shares, where the key condition is that the company is a trading company (see paragraph 18 above).

#### **Availability of entrepreneurs' relief on loan notes pre 6 April 2008**

- 24. When the announcement was made in January 2008, there was considerable concern that the new relief would not assist taxpayers who had already sold shares in their company but had taken part or all of the consideration in loan notes, either qualifying or non-qualifying corporate bonds (QCBs or non-QCBs). The draft legislation includes transitional provisions that go some way to addressing the concerns in relation to QCBs, but nevertheless many QCB holders who expected to pay CGT at 10% will be disappointed, as they will not satisfy the conditions to claim the new relief. Non-QCB holders will be even less satisfied with the transitional rules, as few non-QCB holders are likely to satisfy the relevant transitional relief rules.

#### **Qualifying Corporate Bonds (QCBs)**

- 25. If you have already received QCBs in respect of the disposal of shares in a company then entrepreneurs' relief will be available in respect of any held-over gains that become chargeable on or after 6 April 2008 when the QCBs are redeemed (or otherwise disposed of) if the original sale of the shares would have met the conditions for entrepreneurs' relief if the sale had taken place after 5 April 2008. (Question 2 of the FAQs).
- 26. If you take QCBs after 5 April 2008 on the disposal of shares in a trading company and satisfy the conditions for entrepreneurs' relief there will be no

immediate charge to CGT in respect of the shares and when the deferred gains are brought into charge at the time the QCBs are redeemed or otherwise disposed of then entrepreneurs' relief will be available (Question 14 – final part – of the FAQs).

27. So the rate of tax will still potentially be 10% under the entrepreneurs' relief regime, as it was under the taper relief regime, except that the gain under the new regime will be capped at £1m.

### **Non-Qualifying Corporate Bonds (Non-QCBs)**

28. If you have already received non-QCBs in respect of the disposal of shares in a company then entrepreneurs' relief will only be available if throughout the period of one year leading up to the redemption of the non-QCBs:

- the company that issued the loan notes is a trading company or the holding company of a trading group;
- you own at least 5% of the ordinary share capital and that holding gives you at least 5% of the voting rights in that company; and
- you are an officer or employee of that company or, if it is a holding company, of a company in the same group as the holding company.

(See Question 11 of the FAQs.)

29. If after 5 April 2008 you exchange shares in a trading company for non-QCBs you will be able to elect to have the gain charged at the time of the exchange, and if your shareholding qualifies you will be entitled to entrepreneurs' relief but you will have to pay tax by reference to the tax year of the exchange. If you defer the gain then you will have to satisfy all the qualifying conditions for relief in respect of shares in the company in which you hold the non-QCBs. This is explained in FAQ 14 as follows:

*If the exchange is for .... for loan notes that are not QCBs, entrepreneurs' relief will be available only if you choose for the gain to be chargeable to CGT for the tax year in which the exchange .... for loan notes takes place. So if you exchange shares for .... non-QCB loan notes in July 2008, entrepreneurs' relief would be available only if the gain (net of the relief due) was charged for the year 2008-09, even if the .... loan notes are not sold or redeemed (or otherwise disposed of) until a later tax year. If you do not elect for this treatment the gain could be deferred until the year in which you dispose of the .... loan notes, but in that case no entrepreneurs' relief could be claimed if you do not meet all the qualifying conditions for relief in respect of a disposal of shares in or securities of the company that issued them.*

### **EIS reinvestment relief**

30. The latest FAQs indicate that if you sold a business in, say, July 2003 and reinvested the profits into EIS shares, then entrepreneurs' relief will be available in respect of the deferred gain that comes into charge on the sale of the EIS shares after April 2008 if the sale of the business would have qualified for entrepreneurs' relief had that relief been available in July 2003.

31. If a disposal is made post 5 April 2008 under the new regime and it qualifies for entrepreneurs' relief, then the net gain (after entrepreneurs' relief) can be invested in EIS shares.

### **CGT PLANNING PRE 6 APRIL 2008**

32. Our earlier guidance note (TAXGUIDE 4/07) included some commentary on likely winners and losers – this commentary, updated for entrepreneurs' relief, is set out in Appendix 1. Where clients are likely to lose out as a result of these reforms, they need to consider taking steps before 6 April 2008 to maximise existing reliefs. However, the lead time for a typical sale of an owner managed company can be between six to nine months, so selling a business before 6 April 2008 may not be practical at this late stage.
33. There are a number of possible planning techniques. Some common ones are as follows:
- **Rebasing share values by transfers to trust**  
Where a sale of the company is likely in the near future, it may be beneficial to rebase the shares by transferring them into an appropriate trust. This would create a CGT disposal at market value, which (with full business taper relief) will be charged at an effective rate of 10%. There are a number of different tax issues that need to be considered, particularly IHT, before such planning can be successfully implemented.
  - **Selling shares in the market**  
Many employee/manager shareholders in fully listed and AIM companies will currently benefit from a 10% CGT rate. Subject to prevailing market prices, restrictions on dealing (eg 'closed' periods), dealing costs etc, they may wish to consider triggering their gains at 10% by selling their shares in the market. It is always possible to re-acquire the shareholding but the purchase needs to be more than 30 days after the sale to avoid the anti-bed and breakfasting rule.
  - **Banking indexation relief**  
Taxpayers with substantial accrued indexation relief might want to 'bank' the accrued indexation relief by triggering a suitable 'tax-neutral' disposal which enables the indexation to be rolled up into the asset's base cost. One suggested approach is to transfer the asset to a spouse, but care is required when dealing with assets held by the transferor spouse at March 1982 due to the current drafting of the rules. This may be rectified in the Finance Bill.
34. The above is a brief overview and does not seek to set out all possible planning opportunities. The CGT position of each client will vary depending upon the precise circumstances. Clients' positions will need to be reviewed, paying particular attention to those with business assets and identifying whether or not the business would qualify for the new entrepreneurs' relief post 6 April 2008.

35. Calculations will be needed to compare the CGT position of a disposal of assets before and from 6 April 2008 so that clients can make an informed decision about what action to take. It is important to keep in mind the client's broader commercial and business interests and ensure that any CGT planning is appropriate to the client's circumstances and does not create greater problems elsewhere.

The ICAEW Tax Faculty  
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## Appendix 1

*Extract from TAXGUIDE 4/07, amended to reflect the announcement of entrepreneurs' relief*

### THE WINNERS AND LOSERS

The reform of CGT will create winners and losers. Each case will need to be considered individually but the following general comments may be helpful.

#### **Business assets**

As originally announced taxpayers who disposed of business assets would lose out, because the effective rate of CGT for a higher rate taxpayer on assets that are disposed of after two years would have increased from 10% to 18%. For businesses with gains of up to £1m and entitled to claim the new entrepreneurs' relief, the CGT rate from 6 April 2008 will be only 10%, the same as under the existing business asset taper relief rules.

However, businesses held since before 6 April 1998 and still likely to be worse off due to the benefit of indexation relief reducing the effective rate of CGT below 10%. Particularly badly hit by the changes will be those who hold business assets for the longer term, for example farming businesses and furnished holiday lettings.

In addition, as noted above the availability of entrepreneurs' relief is much more restricted than the business asset taper relief rules.

#### **Non-business assets**

The position is more complicated than for business assets due to the 10-year taper period. Full non-business asset taper relief only applies after assets have been held for 10 years, although those who acquired assets before 17 March 1998 were given a 'bonus year' so those assets became eligible for full taper from 6 April 2007. For many taxpayers, therefore, non-business asset taper relief will still be building up. The main winners appear to be higher rate taxpayers disposing of non-business assets, but as the example below shows the gains may still need to be substantial. A typical example would be a disposal of a second home.

#### *Higher rate taxpayers*

With full 10-year taper relief the effective rate of CGT is 24% so many higher rate taxpayers with non-business assets are likely to be better off disposing of assets after 6 April 2008 and paying CGT at 18%. However, if the gains are relatively modest and the annual exemption is available, taxpayers may be better off with taper relief. For example, if a taxpayer has a gain on an asset of £15,000 and full 10-year taper, the amount of gain charged would be £9,000 which would be covered by the annual exemption (currently £9,200) and no CGT would be payable. Under the proposed rules, the CGT charge would be £1,044, ie £15,000 minus £9,200 at 18%. The break-even position in this situation (assuming there were no other assets) is £33,733 with CGT of £4,416 payable under either method. Where assets have been held for a shorter period of time, non-business asset taper will be lower and the 18% rate is likely to be more beneficial. The position will be more complicated to consider where clients have a portfolio of assets acquired at different times.

*Basic rate taxpayers*

For disposals after 6 April 2008, gains on non-business assets that have been held for three years or under will benefit from moving to the 18% rate; assets held for four years will be taxed at the same 18% rate; whereas assets held for more than five years will lose out as they would have been taxed at a lower rate than 18%. Once again, the precise position will depend upon the availability of reliefs such as the annual exemption and any frozen indexation.

The above comments are necessarily simplified and detailed calculations will be required for each situation. Consideration will also need to be given to the availability of loss relief.