

Introduction

The capital gains tax (CGT) legislation favours business assets by providing a number of tax reliefs. The one with the widest scope is entrepreneurs' relief, which results in certain disposals of businesses being taxed at an effective rate of 10%.

This topic covers the rules for the taxation of business-related capital gains of owners of unincorporated and incorporated businesses, and outlines the various tax reliefs available only on business assets.

It does not cover gains of companies, which are subject to several special rules, such as those in respect of the substantial shareholding exemption. In particular, companies' gains are taxed at corporation tax rates and benefit from an indexation allowance up to the date of disposal.

CGT for businesses

Unincorporated businesses

Individuals, trustees and personal representatives who own unincorporated businesses are liable to CGT on disposals of certain assets of their business.

- The main assets on which CGT can arise are land and buildings, and goodwill.
- Goodwill is essentially the value of the business as a whole less the open market value of its balance sheet assets less liabilities. However, there may be some argument as to the extent to which the goodwill should instead be reflected in the valuation of any trade-related premises.
- Disposals of plant and equipment are only within CGT if sold for more than their original cost.
- Disposals of motor cars, stock, work-in-progress and, in most cases, debts do not result in CGT liability.
- Disposals of agricultural quotas and similar types of asset are liable to CGT.

Incorporated businesses

Shareholders who are individuals, trustees or personal representatives are liable to CGT on gains on disposals of shares. A shareholder is not liable to tax on gains made by the company, except in rare instances not covered in this section.

Entrepreneurs' relief

Entrepreneurs' relief is available for gains arising on disposals of businesses from 6 April 2008, subject to several qualifying conditions. Relief may be given on gains made by individuals on a material disposal. This is the disposal of:

- All or part of a trading business that the individual carries on alone or in partnership.
- Assets of the individual's or partnership's trading business after it ends.
- Shares in an individual's personal trading company or holding company of a trading group.

Since 23 June 2010 the relief applies a 10% rate of CGT to the qualifying gains, irrespective of the level of the taxpayer's other income or gains.

- If the disposal of a business consists of disposals of more than one asset, the gains and losses are added together before calculating entrepreneurs' relief.
- Entrepreneurs' relief is not given automatically: one has to claim it by the first anniversary of 31 January following the end of the tax year of the disposal.
- An individual can claim the relief on more than one occasion up to a lifetime cap of £10 million (from 6 April 2011).
 - The lifetime cap was £5 million between 23 June 2010 and 5 April 2011, £2 million between 6 April 2010 and 22 June 2010 and £1 million before 6 April 2010.
 - The taxpayer is expected to keep a record of the gains on which entrepreneurs' relief has been given.
 - While the responsibility to maintain a record lies with the taxpayer, HM Revenue & Customs (HMRC) will also keep a record.
- Gains that exceed the applicable lifetime cap are taxed at the taxpayers' marginal rate of CGT: 18% or 28%.
- The 10% rate for entrepreneurs' relief applies to the net gain after deduction of any allowable losses (other than any losses on assets that are part of the disposal of the business) and the annual exemption.
- Trustees of certain trusts can claim entrepreneurs' relief under modified rules.

Sole traders and partners

The relief is available on disposals of the whole or part of a business by a sole trader or partner in the business.

- The business qualifies if it is a trade, profession or vocation.
- Property letting businesses do not qualify unless they comply with the special rules for furnished holiday lettings.
- A sole trader must have owned the business throughout the year ending with the disposal.
- A disposal by a partner of their interest in the partnership will qualify if the partner has been a member throughout the year ending with the disposal.
- Where a business ceases without being sold as a going concern, relief is available on assets of the business sold within three years of the cessation.

Personal companies

A personal company is one in which the individual making the disposal:

- Is an employee or office holder of the company, or of a company in the same trading group of companies; and
- Owns at least 5% of the ordinary shares, which carry at least 5% of the voting rights.

These conditions must be satisfied throughout a one-year qualifying period.

- This is normally the year ending on the date of disposal of the shares.
- Where the company ceased trading before the date of disposal of the shares, the conditions must be satisfied throughout the year up to the cessation of the trade, and the disposal of the shares must take place within three years of the cessation.

The employment or office-holding position (director or company secretary) need not be full-time.

'Trading company' and 'trading group' are strictly defined:

- A trading company is a company carrying on trading activities and whose activities do not include substantial non-trading activities.
- A trading group (a holding company with one or more 51% subsidiaries) must meet a similar condition.
- Trade includes activities that qualify as commercial furnished holiday lettings.

A company that invests surplus assets, or lets surplus land and buildings, could fall outside the definition of a trading company if those activities are significant. A company cannot partially qualify for entrepreneurs' relief.

HMRC generally takes the view that a company with more than 20% non-trading activities, income or assets will fail to qualify, however this is not a statutory test.

Investments in joint venture trading companies will not generally jeopardise the investing company's trading status.

Associated disposals

Entrepreneurs' relief is also available on disposals of business assets associated with a sale of shares or a sale of a business by a partner that itself qualifies for entrepreneurs' relief.

- This includes, for example, a property owned personally by a director and used for the company's trade, where the director makes a material disposal of the company's shares, and disposes of the property as part of the same process.
- Likewise, entrepreneurs' relief extends to a partner's disposal of an asset owned personally and used for the partnership trade, where the partner disposes of all or part of their interest in partnership assets and disposes of the property as part of the same event.
- For an associated disposal to attract relief it must be part of a withdrawal by the owner of the asset from participation in the business carried on by the company or partnership.
 - A partial sale of the business interest will permit relief on an associated disposal.
 - The individual need not reduce the work they perform for the business to achieve a withdrawal from the business.
- The assets that are the subject of an associated disposal must have been in use for the purpose of the business throughout the year ending with the relevant disposal or cessation of the business.

Relief on an associated disposal is restricted in the following circumstances:

- Where the asset was in use by or the business for only part of the period of ownership.
- Where only part of the asset was in use for the purposes of the business.
- The owner of the asset was involved in the partnership or company for only part of the period in which the asset was in use for the business (this will be rare).
- The business paid rent for use of the asset after 5 April 2008.

In the first three of these circumstances, the restriction is by reference to the proportions of business and non-business use, for the entire period in which the asset was held. The fourth condition ignores any rent paid for periods before 6 April 2008.

- Where rent was paid, the restriction is based on the proportion of market rent charged over the whole period of ownership.
- Where the owner has borrowed money to buy the asset, charging the business rent was a tax-efficient way of meeting the interest payments.
- Rent is defined very widely as any form of consideration for use of the asset, including licence fees for intellectual property.
- Anyone holding a valuable asset personally which is used by their business may wish to reduce the rent charged, so as to increase the entrepreneurs' relief that might be available on a later disposal of that asset. However, it may be difficult to predict whether such a disposal would satisfy the conditions for entrepreneurs' relief. Also, the rules may change before any later disposal.

Takeovers and reorganisations

Normally, where a person transfers shares in exchange for other shares, this is not treated as a disposal for CGT purposes. Instead, the cost of the old shares is treated as the cost of the new shares. The whole gain is then liable to CGT when the new shares are disposed of.

Often on such a takeover, the transfer of the old shares would qualify for entrepreneurs' relief if it were a disposal, but the acquiring company does not become the shareholder's personal company and so a later disposal of the new shares would not qualify for entrepreneurs' relief.

- Where the share exchange takes place after 5 April 2008, the shareholder can elect for it to be treated as a disposal for CGT purposes at the time of the share exchange and so claim entrepreneurs' relief at that point.
- The gain after relief is then taxed at 10%.
- If the shareholder elects for the relief to apply they will have to pay CGT on the gain at 10% when no cash may have been received as part of the share for share exchange.

If shares are exchanged for loan notes that are qualifying corporate bonds (QCBs), normally the chargeable gain on the disposal of the old shares is deferred until the disposal of the loan notes. Where the exchange occurs after 5 April 2008, entrepreneurs' relief may be claimed and deducted from the gain to be deferred. However, further changes were made on 23 June 2010, so the taxpayer must choose between claiming entrepreneurs' relief at the date of the exchange of shares for loan notes, or holding over the gain.

- Most loan notes are structured as QCBs.
- Where shares are exchanged for QCBs before 23 June 2010 the taxpayer can claim entrepreneurs' relief in calculating the gain to be deferred as a result of an investment in qualifying shares under the EIS (see the separate topic 'Capital gains tax for business owners'). Only the balance of the gain after applying entrepreneurs' relief is deferred.
- Where the disposal of the old shares took place before 6 April 2008, transitional rules allow a claim for entrepreneurs' relief if the original disposal would have qualified for entrepreneurs' relief if it had existed at the time. The relief is given on the disposal of the QCBs or new shares or when the gain comes into charge for another reason.

Replacement of business assets

Rollover relief allows a person carrying on a trade to replace certain fixed assets without having to pay CGT on any gain arising on the disposal of those old assets. Where all the disposal proceeds are reinvested into new assets, the gain on the old assets is in effect deducted from the cost of the new assets, and in broad terms becomes chargeable only when the replacement asset is eventually sold without being replaced.

- The new assets must be acquired within a period starting one year before and ending three years after the disposal of the old assets, although HMRC sometimes extends these time limits.
- Relief is restricted if only part of the sale proceeds of the new assets is reinvested or if the old asset has not been used for business purposes throughout the period of ownership.
- Both the old and the new assets must be from the following list:
 - Land and buildings occupied and used exclusively for trade purposes.
 - Fixed plant or machinery that does not form part of a building.
 - Ships, aircraft, hovercraft, satellites, space stations or spacecraft, including launch vehicles.
 - Goodwill.
 - Agricultural quotas for milk, fish, ewe or suckler cows, and entitlements under the EU agricultural single payment scheme.
 - Lloyd's syndicates capacity from 5 April 1999.
- Individuals can claim relief for assets used in certain activities other than trading. The rules are modified in some of them. The activities are:
 - Exercising a profession.
 - Furnished holiday lettings. The lettings must comply with a number of requirements, which are explained in the separate topic 'Property letting'.
 - Occupying commercial woodlands and managing them to make a profit.
 - Employment.
 - Providing an asset to a personal company. In this case, this is a company in which the individual is able to exercise at least 5% of the voting rights.
- The new assets do not have to be used in the same trade as the old assets. It is also possible to roll over a gain from selling trading assets into the purchase of property for furnished holiday lettings or certain commercial woodlands.
- Rollover relief is modified when reinvestment in wasting assets (assets with a predictable useful life of less than 50 years) or assets that will become wasting assets within ten years.
- Where the reinvestment is a wasting asset, the capital gain can only be deferred for up to ten years, or, if earlier, until the asset is disposed of or is no longer a business asset.

Rollover relief on incorporation of a business

A form of rollover relief is available when an unincorporated business is transferred to a company in exchange for new shares.

- For CGT purposes, such a transfer is normally a disposal of the assets, including goodwill, at market value.
- The chargeable gain that would otherwise arise on the transfer is deducted from the issue price of the shares. The issue price is normally the full value of the assets transferred.
- The relief has the effect of lowering the base cost of the shares and deferring the chargeable gain until the shares are disposed of.
- All the assets of the business, or all the assets except cash, must be transferred to the company, and the business must be transferred as a going concern.
- Partial relief is available where the business is transferred partly for cash and partly for shares.
- The relief is given automatically on business transfers that qualify, but it is possible to opt out of it.
- Normally a subsequent disposal of the shares should qualify for entrepreneurs' relief, but if that is unlikely, it might be advisable to opt out of the rollover relief and claim entrepreneurs' relief on the incorporation.
- One circumstance where a subsequent sale of the shares would not qualify for entrepreneurs' relief is if the shares were to be sold within a year of incorporation. They would then not satisfy the one-year ownership condition.
- Where only partial rollover relief is available because part of the consideration for the transfer of the business to the company is in cash, the remaining chargeable gain may be reduced by entrepreneurs' relief.

Gifts of business assets

Holdover relief is available to individuals or trustees who dispose of business assets, including shares of unlisted trading companies and shares in the shareholder's personal trading company, otherwise than under a bargain at arm's length.

- For CGT purposes, such a transfer is a disposal of the assets at market value.
- The personal company is one in which the shareholder holds 5% or more of the voting rights (note this is not the same definition of personal company as applies for entrepreneurs' relief).
- Where relief is claimed, the transferor's chargeable gain is in effect deducted from the transferee's base cost of the asset.
- Normally, this means that the transferee takes over the transferor's base cost plus indexation up to April 1998 where relevant. (Indexation, which existed from March 1982 to April 1998, uplifted the cost of an asset by reference to the retail prices index (RPI).)
- Partial relief is available where the transfer is not an outright gift but the consideration paid is less than the market value of the asset.

- Relief must be claimed jointly by the transferor and transferee, except where the asset is transferred to a trust, in which case the transferor can make the claim alone.
- The relief enables business assets to be passed on within a family or placed in trust without a liability to CGT.
- The relief is at the cost of the tax-free uplift to market value of assets held at death if the donor had kept the assets.
- It also provides a means of incorporating a business other than by a transfer of business assets in exchange for shares.
- Holdover relief is given before entrepreneurs' relief, so the gain held over cannot be reduced by entrepreneurs' relief. The donee may be able to make their own claim to entrepreneurs' relief on a subsequent disposal.
- Transfers of shares only qualify for holdover relief if the shares are held in a trading company or holding company of a trading group with trading defined under the same rules that apply to entrepreneurs' relief. This excludes shares in companies with substantial non-trading assets.
- Holdover relief is not available for transfers of assets to a trust where the person transferring the asset, or anyone else who has put assets into that trust, can benefit in any way from the trust.

Deferment of gains under the EIS

Any chargeable gain can be deferred by reinvesting the gain in shares that qualify under the EIS.

- The reinvestment must take place within one year before or three years after the gain arises.
- Any size of gain may be deferred.
- Unlike with the EIS income tax relief, individuals claiming CGT deferral can be directors or employees of the company in which they are investing and can hold more than 30% of the share capital.
- This provides scope for individuals to defer gains by investing in their own company.
- The company must meet several conditions for investment in its shares to qualify. The most important ones are:
 - It must be unlisted. Companies on the Alternative Investment Market (AIM) are treated as unlisted.
 - The value of its assets must not exceed £7 million before the investment and £8 million immediately afterwards, although these limits are expected to be increased in 2012.
 - The company, or its subsidiaries, must carry on a qualifying trade. Many asset-backed trades and subsidiary supported trades are excluded.
- The deferred gain becomes chargeable on a disposal of the EIS shares, or where the shares cease to qualify under the EIS, or where the investor receives significant value from the company that issued the EIS shares.

- Where the initial disposal took place before 6 April 2008, entrepreneurs' relief may be claimable under transitional rules similar to those for QCBs, as described under the separate topic 'Capital gains tax for business owners'.
- If entrepreneurs' relief is claimed on the initial disposal (where that is after 5 April 2008 and before 23 June 2010), only the gain after entrepreneurs' relief is deferred.

Losses on new shares in unlisted companies

Relief against income tax is available for capital losses made by an individual who has subscribed for shares in certain unlisted trading companies. While a taxpayer does not normally invest to make a loss, the relief helps mitigate the effects of any capital losses that may arise.

- Relief for the loss can be claimed against income for the year in which the loss was made or for the immediately preceding tax year.
- Claims must be made within one year from 31 January in the tax year following the loss, e.g. by 31 January 2013 for losses realised in 2010/11.
- All shares issued under EIS will qualify for this relief.
- For other shares issued after 5 April 1998, the qualifying conditions are very similar to the EIS conditions. In particular, the company must not be engaged in trades that are excluded by the EIS and must not have gross assets of more than £7 million before and £8 million after issue of the shares.
- The relief is available to directors as well as other individuals.
- There are a number of other conditions to the relief. In particular, the loss must arise from a disposal of the shares at arm's length, the deemed disposal as a result of a negligible value claim, or as a distribution as part of the dissolution or winding-up of the company. The disposal must take place within three years of the company ceasing to trade.

Relief for trading losses against chargeable gains

A person who makes a loss in a trade, profession, vocation, or in rare instances an employment, can claim relief for that loss against their other income of the same tax year or of the preceding tax year.

- The relief can be optionally extended to the taxpayer's net chargeable gains of the year for which the income tax claim is made.
- The losses are then treated as allowable capital losses of that year.
- A claim results in trading losses being relieved at the appropriate CGT rate.
- In some circumstances, it might be better to wait for the trading losses to be relieved against future trading income, rather than claim a smaller amount of immediate relief.

Company sales

Sale of the business by the company

A buyer of a business will often prefer to buy the trade and assets from the company rather than the company itself. This often has tax disadvantages for the seller, because the company will be

liable to tax on the sale and the seller will also be taxable when the sale proceeds are distributed. It is generally better to sell the shares than the assets.

Sale of the company's shares

Companies are sometimes sold wholly or partly in exchange for shares or loan notes. In either case, the chargeable gain on the sale is normally deferred until a disposal of the shares or loan notes for cash.

- A sale of a company A in exchange for shares in another company B is not a disposal.
- But the seller can elect for the sale of shares in company A to be treated as a disposal to permit a claim for entrepreneurs' relief.
- Entrepreneurs' relief may not be available on the sale of the company B shares, if company B does not qualify as the individual's personal company.
- Where the shares in company A are exchanged for QCBs, the gain on the shares in company A is deferred until disposal of the QCBs.
- If entrepreneurs' relief is claimed on the disposal before 23 June 2010 of shares in company A, only the gain after deduction of entrepreneurs' relief is deferred.
- Sometimes the terms of the loan notes are deliberately structured in such a way as to ensure the loan notes are not QCBs.
- The CGT consequences are then similar to a sale in exchange for shares.
- QCBs in themselves cannot qualify for entrepreneurs' relief because gains arising on QCBs are not chargeable gains and any loss is not an allowable loss for CGT. However, relief is available on gains, deferred by acquiring the QCB if the individual otherwise meets the conditions for relief in respect of the deferred gain.

There are other important differences between shares and loan notes, and the commercial risk of accepting paper rather than cash should be taken into account in any sale of a company. Special care should be taken over the tax consequences of earn-out deals, where deferred consideration is payable dependent on the company's future results. The complexities of such sales are beyond the scope of this section.

Tax planning key points

- For individuals, the main focus of capital gains reliefs is to ensure that the taxpayer is adequately rewarded for the risk of investing in a trading business, is offered an incentive to reinvest (business asset roll-over relief, the EIS, etc.) and does not suffer from merely changing the legal form of the business (incorporation relief).
- The conditions for entrepreneurs' relief must generally be met for at least one year up to the date of sale of the business or company shares, or to the date the business ceased trading.
- Companies often operate as a group, and relief is available when assets are moved from one member of a group to another and when the group as whole reinvests the proceeds of a sale. There are a number of reliefs that facilitate restructuring. Of particular interest is the exemption for the sale of a substantial shareholding.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at September 2011, which are subject to change.