Too soon to say goodbye

JULIE BUTLER considers the consequences of leaving in haste when capital gains tax entrepreneurs' relief is at stake.

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The conditions to qualify for capital gains tax entrepreneurs' relief are onerous. It is a condition that, when there is a disposal of shares, the vendor must be a director or employee throughout the year leading to the disposal. In reality, many directors leave in haste and then sell their shares by some form of 'post-departure agreement for sale'. Many would argue that, from a practical point, remaining as a director provides an improved position of strength for negotiation as well as tax relief.

The First-tier Tribunal decision in *J Moore* (TC4903) shows the capital gains tax consequences of not staying on as director until the shares have been sold to meet the complex conditions of qualifying for entrepreneurs' relief.

Founding shareholder

Mr Moore was a founding shareholder and director of the company which had been established in 1995. During 2008, after a disagreement among the directors, he left. In January 2009 the company and Mr Moore agreed a company buyback of his shares, along with an ex gratia payment as part of the termination of his employment on 28 February 2009. The Companies Act 2006, s 693 and s 694 require the company's own purchase of shares to be approved by special resolution. This was passed on 29 May 2009.

Because the date (February 2009) Mr Moore ceased to be employed was *before* the date of sale of the shares (29 May 2009), his claim for entrepreneurs' relief on their disposal (TCGA 1992, s 169H) failed. HMRC had dismissed the claim on the ground that Mr Moore was not an employee throughout the year before the sale.

This might seem a sad irony given that he had been employed by the company for more than 13 years before the disposal, but the transaction did not comply with the legislation by only a few months. The result in broad terms was that capital gains tax at the rate of 28% would be paid as opposed to the 10% rate under a successful entrepreneurs' relief claim.

Mr Moore's appeal was dismissed by the First-tier Tribunal because, although he considered the disposal to be 'sometime' in February 2009, the tribunal considered the sale to be 29 May 2009. As a result, Mr Moore did not qualify for entrepreneurs' relief because he was not a director or employee in the 12 months before the date of disposal of his 2,700 shares. The tribunal considered that, under TCGA 1992, s 28 the date of disposal is when the unconditional contract for the transaction is made. In this case, the date was that of the special resolution for the company to buy 2,700 of Mr Moore's 3,000 shares.

This case provides sad but clear generic guidance that all tax planning must be put in place before the transaction under review. The decision also highlights the need to plan for entrepreneurs' relief and to ensure that all conditions are understood and complied with in the legal agreements before they are agreed and signed.

KEY POINTS

- Timing departure as an employee or director when selling shares in the company.
- What constitutes continuing employment duties?
- The impact of the new reduced 20% rate of capital gains tax.
- Importance of tax planning before completing transactions.

Earlier guidance

Two cases from 2014 provide earlier guidance on this aspect of capital gains tax entrepreneurs' relief.

In *Hirst* (TC4038), the First-tier Tribunal held that Mr Hirst remained an employee throughout the relevant one-year period ending with his sale of the shares, notwithstanding that Mr Hirst had previously resigned his position with the company. It was agreed that the disposal was eligible for entrepreneurs' relief.

What were the reasons?

The tribunal accepted that Mr Hirst had not been paid commission entitlements due to personal circumstances. However, his financial needs were satisfied by company dividend payments. In addition, the company had continued to provide him with a telephone and laptop, as well as meeting the costs of his home internet contract. These conditions were deemed to qualify as employment for entrepreneurs' relief purposes.

In every case the quality of the evidence of employment must be considered. An 'employment' is defined as including any employment under a contract of service (ITEPA 2003, s 4). A written contract of employment will normally help, although whether an individual is an employee is a question of fact.

In *Corbett* (TC3435), the tribunal decided that Mrs Corbett was entitled to entrepreneurs' relief on a sale of shares. It was held on the facts that she remained an employee of the company despite having been removed from its payroll several months before the shares were sold. It is important to note here that her employment duties had continued, and her remuneration was redirected to her husband.

New rates from April 2016

From 6 April 2016, the 28% rate of capital gains tax was reduced to 20%. How will this reduction affect entrepreneurs' relief?

The drop to 20% might seem less painful in tax terms, but there is still every reason to plan ahead for all proposed disposals that wish to achieve entrepreneurs' relief at 10%. Many business decisions happen first and only afterwards is any consideration given to tax planning.

If, in *Moore*, the special resolution for the buyback had been on the same day as the termination and ex gratia payment, the claim for entrepreneurs' relief made by the taxpayer should have been valid.

> ***"The case highlights the need for directors and employees to secure the correct paperwork and timings for transactions."***

The case highlights the need for directors and employees to secure the correct paperwork and timings for transactions that seek entrepreneurs' relief.

Likewise, future transactions seeking entrepreneurs' relief, such as the sale of development land, should be planned in advance of the disposal.

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RIPE FOR REFORM?

Mr Moore may well feel that the tax system has treated him unfairly here. A confusion over dates and paperwork has prevented him obtaining the relief which would otherwise have been due. Had the significance of the various dates been appreciated, it might have been possible to structure matters differently. But it is worth reflecting on the general principle here. Should loss of employment status before sale automatically lead to a loss of relief? I think a case could be made that the legislation should have a period of grace so that a delay in disposal after cessation of employment does not mean that relief is lost. Would there really be a risk to the exchequer if there were, say, a three-month window after the cessation of employment during which a sale could be made.

It is worth looking at how reliefs dealt with this issue previously. Retirement relief had a basic requirement that an individual had to be a full-time working director. However, FA 1985, s 69(7) allowed a limited form of relaxation. As long as the individual remained a director they could reduce their working time to an average of ten hours a week in a technical and managerial capacity.

Taper relief originally had a full-time working requirement, but that was abolished from 6 April 2000. From that date, all that was required was either that the individual had a 5% voting interest in the company or that they were an employee. So most people in Mr Moore's position would not have lost out if they had ceased employment before the sale. But even had the qualifying conditions failed that would not have been conclusive. Taper relief worked on a time-apportionment basis, so taxpayers still retained the benefit of business taper relief for qualifying periods: it did not depend entirely on the conditions prevailing on the date of disposal.

It would be difficult to apply the taper relief principle of time apportionment to entrepreneurs' relief because of the different way in which it works, but perhaps some modernised form of the retirement relief principles could be made to work for people like Mr Moore. There seems no public policy reason imperative to require an individual to remain an employee right up to the date of sale.

Andrew Hubbard