TECHNICAL RELEASE

TAXGUIDE 07/15 (TECH 10/15TAX)

FINANCE ACT 2015 CHANGES TO ENTREPRENEURS' RELIEF

Note of meeting with HMRC published by ICAEW Tax Faculty in September 2015

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FOREWORD

Finance Act 2015 introduced some changes to Entrepreneurs' Relief (ER) restricting the conditions under which the relief could be claimed. It was considered by many professional groups that the new conditions were preventing claims for ER in circumstances not intended; the matter was discussed at the Capital Taxes Liaison Group on 1 May 2015 and the minutes and associated ER briefing paper were published by ICAEW as TAXguide 02/15. Following this meeting ICAEW submitted a paper outlining the problems; see TAXrep 36/15 as did the CIOT, see their submission here.

As a result HMRC invited ICAEW and CIOT and other professional bodies to a meeting to discuss the problems. This meeting was held on 18 August 2015 and was preceded by a meeting of the interested professional bodies on 13 August 2015. The meeting on 13 August led to the production of the paper Entrepreneurs' Relief FA 2015 changes – proposed solutions paper to be used as the agenda for the meeting on 18 August.

The notes of the meeting on 18 August were passed to HMRC for review; the minutes as reproduced below incorporate HMRC's comments. For the avoidance of doubt HMRC have not agreed these minutes but have agreed that we can publish them.

MINUTES OF MEETING HELD 18 AUGUST 2015 WITH HMRC

MEETING:	To discuss entrepreneurs' relief changes with HMRC
DATE & TIME:	18 August 2015 at 1030-1230
LOCATION:	CIOT, Artillery Row
CHAIRMAN:	Rob Clay (HMRC)
SECRETARY:	Sue Moore (ICAEW)
ATTENDEES:	Aparna Nathan (CIOT) Lynnette Bober (ICAEW) James Gopsill (Gateley) Louise Speke (CLA) Wyndham North (HMT) Pete Miller (CIOT/ICAEW) Tim Crosley (Law Society) Tim Hughes (BVCA) Charles Pascoe (CBI) Mike Houghton (HMRC)

ITEM DETAILS

RC opened by saying that ER had received a lot of attention from the Audit Commission because of the scale of the relief given and that, in part, was the background behind the changes in the legislation. The mechanical way that ER works results in outcomes and consequences in terms of relief given that were not intended and although it was believed that the blocking introduced was effective it was recognised that some of the changes have gone beyond the intended scope.

It was agreed to work through the paper produced by the professional group following their meeting on 13 August 2015, see attached, and discuss and flesh out the ideas included in that paper.

1 Joint ventures/feeder companies

Finance Act 2015 section 43(2) inserting section 169S(4A)(a) 'subsections (7) and (12) of section 165A are to be disregarded'.

RC stated that the new measure was introduced to stop "contrived" structures but RC recognised that it catches some "genuine" business structures. A large number of claimants were able to access ER on a trading company; the measure stops claimants where there was indirect ownership of the trading company. The idea of using a look through to calculate the actual percentage owned by each ER claimant (shareholder") was attractive but it appeared complicated if the Holding Company ("Holdco") had more than one than one subsidiary or joint venture company (JVC). If the Holdco had only 51% subsidiaries then the position is unchanged by the new legislation: it is only if there is a JVC that there is an issue. If a shareholder owns 100% of Holdco which has a 20% holding in a JVC then the shareholder has a 20% stake in the JVC so the shareholder should qualify for ER. If the shareholder has a 10% stake in Holdco then his interest in the JVC is only 2% and so as it is less than 5% it does not qualify for ER.

Concern was expressed that there may be some growth in value in the Holdco not attributable to the JVC and how could that be stripped out? However, it was noted that this situation is no different to any company and the normal tests of wholly or substantially trading should still be applied to see if ER is potentially available before looking at the percentage holding. If the non trading activity was substantial there would be no ER on anything, cf substantial shareholding rules. ER applies to all or none of the gain. The availability of ER would need to be looked at on a shareholder by shareholder basis once it was established that the company qualified as a trading company, the attribution of ER or not would be for each individual shareholder. It was thought that

any conflicts could be finessed out.

This mechanistic approach chimed with the rest of the ER legislation. A TAAR may well require an advance clearance system and hence deployment of resources so a mechanical approach is preferable. It was thought reasonable by those present for an individual shareholder to have the necessary knowledge of the group structure in simple cases and in more complex cases there were likely to be complex agreements for the structure.

Outcome

RC thought the proposal had merit and as a next stage HMRC would work up some examples to share with the group.

HMRC acknowledged representatives' request for any legislative changes to be backdated, but said that they would need to take legal advice on this point. Representatives further suggested that there could be an election such that taxpayers could elect for backdating to not apply..

The HMT and HMRC representatives considered it extremely unlikely that changes could be included in Finance Bill (No 2) 2015 nor was it likely they would be in the Autumn Statement but that did not preclude them from being in Finance Bill 2016. Those attending stated that the sooner the unintended consequences of the FA 2015 changes were announced and implemented the better: it would end the period of profound uncertainty experienced by many ER claimants.

2 Partnership activities treated as not being trading activities: Finance Act 2015 section 43(2) inserting section 169S(4A)(b) and (c)

Partnerships had been drawn into the revised legislation as it was thought that investors in JVC thwarted by the new legislation would move into partnership structures instead.

Based on experience it was commented that venture capitalists do not like partnership structures so perhaps the worries regarding side stepping the new JVC rules were over estimated.

The Representatives felt strongly that there should be no difference between investing via a company and investing via a partnership. Taxpayers should be free to choose the entity that worked best for them commercially and there should be no difference that would allow for potential tax arbitrage in the future.

The paper set down three proposals which the Representatives felt would in combination achieve the objective set down above:

- use the same numerical test for partnerships as proposed for JVC;
- replace the reference in s169S(4A)(b) and (c) to 'not being trading activities' with a disregard (as for s169S(4A)(a)) to ensure consistency with JVC;
- treat a 51% interest in a partnership in the same way as a 51% interest in a company

Outcome

RC thought the proposals had merit and would be further investigated with his counter avoidance colleagues.

3 Associated disposals FA 2015 section 41 amending TCGA 1992 section 169K in particular 'partnership purchase arrangements' section 169K(6)

The changes caused problems for normal succession of businesses and there are particular problems for family farming partnerships.

HMRC asked why the final bullet   about farming assets being kept outside the partnership was made on the paper prepared by the Representatives (attached). It was explained that it was there as the suggested solution by HMRC in the Briefing paper produced for the Capital Taxes Liaison Group meeting on 1 May 2015 was to put the asset in the partnership, see ICAEW TAXguide

02/15 and CIOT website.

The possible solutions:

- the proposed solution (associated disposal can qualify for ER where a shareholder holds less than 5% in the company provided that he disposes of the entire interest) can be considered and discussed with counter avoidance colleagues.
- in principle normal genuine succession should not have been caught by the changes.
- HMRC had been considering a TAAR. This was discussed and it was felt that wording along the lines of 'arrangements are not fatal to a claim for ER if they are in pursuit of bona fide succession purposes' might be acceptable.
- option given to existing partners to purchase the share of a retiring partner not precluding claim to ER if in the partnership agreement but not all partnerships have written agreements

HMRC did not feel that it was necessary to restrict the definition of connected as the restriction required (that an individual is not connected with partners if they are connected solely as partners in a bona fide commercial transaction) was covered by TCGA 1992 s286, it was felt that pointing that out in guidance would be helpful.

The purpose of the blocking measure was to prevent a claimant from buying/clawing back the asset they have claimed ER on. It is difficult to retain this legitimate block without stopping legitimate succession claims.

Outcome

HMRC is considering "weakening" the block such that arrangements existing at the time of disposal and not done for a tax motive are not caught. This could be done by way of a broad GAAR on CGT transactions or a narrower TAAR on ER transactions.

HMRC is ambivalent as to which proposal is the best or if an amalgamation would work best, and will consider the proposals made.

'Partnership purchase arrangements' and 'share purchase arrangements'

Gifts are excluded so no change required but HMRC will check if the assumption of liabilities stops it being a gift.

What is a 5% interest in the 'partnership assets'?

HMRC have a flexible approach to this in line with SPD12. Generally it would be looking at the capital sharing ratio and chargeable assets.

4 Finance Act 2015 section 42 Entrepreneurs' relief: exclusion of goodwill on incorporation

ER on the sale of goodwill on incorporation of a business together with tax relief for the subsequent amortisation of the goodwill was not an intended consequence of the original ER legislation. The provisions in FA 2015 to block both of these have been drafted in tandem. The change to the ER legislation was intended to stop the incorporation of businesses which, by virtue of the loan created on the acquisition of the goodwill and assets that is owed by Newco to the individual/partner, in effect allows future income streams to be taxed as capital not as income. The Explanatory Notes to the Finance Bill 2015 explained that the changes were introduced to stop the avoidance of income tax and NICs. However the change to the ER regime, in particular the close company concept and the width of the concept of "related party", prevents ER from being available to partnerships which incorporate for genuine commercial reasons and not for the avoidance of tax.

As it stands the effect of section 169LA is that it deters partnerships from incorporating and as

such will inhibit partnerships from attracting third party equity investment. This is because investors, such as pension funds and venture capitalists, want to acquire shares in a company not a slice of a partnership. The market for partnership interests as opposed to the market for share capital is not developed and therefore is not attractive to investors who ultimately seek an exit for their investment. There is no public market for partnership interests and consequently it is not possible to float a partnership on the UK stock market. The only way such a partnership can float is to incorporate the partnership's trade and then float the shares in Newco.

The technical problem with Section 169LA is that the company which acquires the partnership will invariably be close both before and after incorporation because all partners are connected with each other under CTA2010 s1122. All partners are also "related parties" as regards the buying company. In this regard it was noted that after incorporation the old partnership often has to continue to exist for a short time run-off purposes even though the business has been transferred and therefore the shareholders in the Newco continue to be "connected". Any amendment to the legislation (so far as close company or related party) would have to take this into account.

In the context of the legal profession the changes within Section 169LA cuts across one of the key objectives that lay behind the Legal Services Act 2008. The policy objective behind that Act (and the Clementi Report pursuant to which that Act was adopted) was to encourage law firms to be more entrepreneurial and allow members and partners to be non-lawyers. Consequently the Act allowed law firms to obtain a licence to become an "Alternative Business Structure" ("ABS") one of the benefits of which would enable them to raise equity finance by means of third party investors who are non-lawyers. As explained, third party investors seek a traditional investment model (and therefore exit route) and this is in practice much more achievable if the law firm is able to offer the investor share capital rather than membership of the partnership.

Outcome

Serious consideration will be given to (a) retaining a de minimis stake (finessed for family businesses where connected party holding would result in a de minimis being exceeded) in a succeeding company (b) caveating Section 169LA with a counter-avoidance provision and or (c) inserting a provision which disapplies connection or association via partnership alone. Consideration will also be given to dropping or modifying the related party provisions on a genuine sale.

These suggestions will be discussed with counter-avoidance colleagues.

5 Finance Act 2015 section 42 Entrepreneurs' relief: exclusion of goodwill on incorporation

Outcome

The points made will be considered.

6 Finance Act 2015 section 42 Entrepreneurs' relief: exclusion of goodwill on incorporation

The changes made to ER have highlighted an inconsistency in that on incorporation under TCGA 1992 s162 the period of ownership before and after incorporation are not amalgamated.

Outcome

HMRC will consider an amalgamation of the periods of ownership.

7 Appendix – potential redraft of section 169LA TCGA 1992

Section 169LA TCGA 1992 was inserted into the legislation by Finance Act 2015 section 42; the issues with section 169LA and the potential solutions were discussed at some length but the

redraft of the section was not discussed.

8 Conclusion

HMRC and HMT will discuss the problems and proposed solutions with colleagues.

Although it is unlikely that there will be anything in the Autumn Statement there is still scope for changes to be made in Finance Bill 2016. Concern was expressed regarding the self assessment filing deadline of 31 January 2016 (some of the changes being effective from 3 December 2014) and whether or not any indication could be given as to the amendments to be made to the legislation to assist taxpayers affected in the 2014/15 tax year. HMRC recognised these concerns.

PROPOSED SOLUTIONS PAPER

Meeting 13 August 2015 at the CIOT resulted in this

Entrepreneurs' Relief FA 2015 changes – proposed solutions paper

[Note: Suggestions made in the form of new draft legislation are intended only as example forms of legislative wording that might be employed to achieve the proposed solution.]

1. Joint ventures / feeder companies

Finance Act 2015 section 43(2) inserting section 169S(4A)(a) 'subsections (7) and (12) of section 165A are to be disregarded'.

Policy aim[1]: stop ER being allowed on shares where the claimant does not have the necessary 5% stake in a company which is either a trading company in its own right or the holding company of a trading group

Problem identified: potentially denies ER to shareholders of all companies where a substantial part of the activities are carried on through joint venture companies, regardless of the shareholder's underlying interest in the trading activities.

Suggested alternative mechanism

Allow indirect participation in a trading company provided the effective ownership of the trading activities remains greater than the 5% threshold by inserting "if the indirect ownership is less than the thresholds set out in subsection (3)", i.e. (a) subsections (7) and (12) of section 165A are to be disregarded ***if the indirect ownership is less than the thresholds set out in subsection (3)***

The indirect ownership would be calculated by introducing an arithmetical test of underlying ownership. This could be based on sections 1156 and 1157 CTA 2010, multiplying out the relevant shareholding thereby preventing the targeted abuse. Those provisions only refer to ordinary share capital, so a test of voting power would also be required, for consistency with the requirements for ER generally.

For example, the target of the policy would be maintained as a person with a non-qualifying 2% shareholding in TradeCo sets up a structure to access ER by holding a 100% shareholding in Manco which in turn holds 2% in JVCo. In this case, ER is not available because 100% of 2% is still 2%. Alternatively, a person owns all the shares in a company that has a 50% joint venture holding. Here, the shareholder's overall interest in the joint venture company is 50% and ER should be available.

Amendments to take effect from 18 March 2015.

Transitional rules may be needed for anyone who has sold shares since that date and not been allowed to claim ER and whose returns have become final before amending legislation is enacted.

[1] HMRC Brief for Capital Taxes Liaison Group 1 May 2015

2. Partnership activities treated as not being trading activities: Finance Act 2015 section 43(2) inserting section 169S(4A)(b) and (c)

Policy aim: stop ER being allowed on shares where the claimant does not have the necessary 5% stake in a company which is either a trading company in its own right or the holding company of a trading group

Problem identified: potentially denies ER to shareholders of all companies where a substantial part of the activities are carried on through partnerships, regardless of the shareholder's underlying interest in the trading activities.

Alternative mechanism

As with JVs/feeder companies, a solution based on allowing ER where there is at least a 5% holding based on a similar arithmetical test to that proposed above. Since partnerships do not have shares, this might need to be based on the partnership sharing arrangements, as in section 1262 CTA 2009. Where there are different arrangements for capital and profits, the smaller of the two could be used. Similarly, if the arrangements vary during the relevant period (i.e. the 12 months prior to sale, the test could use the lowest right to profits share or capital in the period).

In addition to the indirect ownership test, remove the reference in s169S(4A)(b) and (c) to 'not being trading activities' and replace with a disregard (as for s169S(4A)(a)) to ensure consistency with JVs and to prevent tainting of the company's directly held activities for shareholders who would otherwise qualify for ER on a numerical test.

The new rules also throw up another inconsistency of treatment between joint ventures and partnerships. If a holding company P owns 51% of a trading company S, S is treated as a group company for ER purposes, so a 5% shareholder of P can claim ER if S is a trading company. If, instead, P were to have a 51% interest in a trading partnership, the current (FA 2015) legislation denies ER to a 5% shareholder of P.

A potential solution to this inconsistency might be to treat a controlling (i.e. 51%) interest in a partnership in the same way as a 51% holding of a company, i.e. H is effectively treated as carrying on all the activities of the 51% owned entity.

Amendments to take effect from 18 March 2015

3. Associated disposals FA 2015 section 41 amending TCGA 1992 section 169K in particular 'partnership purchase arrangements' section 169K(6)

Policy aim: Prevent ER being due on disposals where there are arrangements by which the claimant (or persons connected with him/her) can recover the shares/assets disposed of: an anti-avoidance provision.

Problem identified: that the terms of the new s169K (1A)(b) TCGA 1992 may go much wider than is necessary to prevent the avoidance referred to and will discriminate against family partnerships thus denying the availability of ER where there is:

- a written partnership agreement with a clause that enables other family members to acquire and increase their interest in the partnership on the retirement or death of a partner.
- land used within the partnership is owned outside the partnership (for example to allow land to be left by will on terms which benefit other family members not involved in the partnership business).

Possible solutions:

- Amend section 169K TCGA 1992 to include a provision such that where the individual is disposing of a share of less than 5%, provided that disposal amounts to the whole of his retained interest, the associated disposal will qualify for ER.

- Amend section 169K to exclude 'partnership purchase arrangements' for a genuine succession;

  (1AA) Subsection 1A(b) above shall not apply where (i) and (ii) below apply.
  (i) Both the relevant material disposal and the disposal associated with the relevant material disposal are made to an individual who is a member of the partnership in question (or will become such a member on completing the purchase of the interest in the partnership) and
  (ii) P's disposal of his interest in the partnership comprises his entire interest therein.

  [Wording to embrace situations where several partners acquire P's interest in the partnership and more than one partner acquires the asset which is the subject of the associated disposal.]

- Exempt the normal "retirement" or "death" arrangements in a partnership agreement

- Adopt a more restrictive definition of 'connected' to exclude partners that are connected solely as partners in a bona fide commercial transaction

Any legislative amendment to take effect from 18 March 2015

'Partnership purchase arrangements' and 'share purchase arrangements'

Whether gifts are excluded (for example in the case of a gift of a partnership share there may be consideration given in the form of an assumption of liabilities) If not, a legislative solution needed based on nil monetary consideration and excluding the assumption of liabilities

What is a 5% interest in the 'partnership assets'?

Does 'partnership assets' refer to capital sharing ratio or to partnership assets that are beneficially held, or to some other measure? Does 'assets' mean chargeable assets only?

We assume that the answer is respectively capital sharing ratio and chargeable assets.
If so, the suggested solution is clarification (in guidance as matter is one of normal interpretation) of HMRC's view.

4. Finance Act 2015 section 42 Entrepreneurs' relief: exclusion of goodwill on incorporation

Policy aim: stop ER being allowed on incorporation by sales of a trade into a company under the same economic ownership where the purpose of the incorporation is to avoid income tax and or national insurance contributions.
Problem identified: potentially denies ER where there is a commercial disposal of shares to a genuine third-party company where the previous traders are expected to take an equity stake. This may well be less than 5%, so they are permanently denied ER.
Possible solutions

- Allow for ER provided that the shareholding in the successor company is less than 5%
- To include a TAAR adding "and" to subsection 169LA(1)(c) and adding new subsection 169LA(1)(d), as suggested in the appendix.

Amendments to take effect from 3 December 2014

5. Finance Act 2015 section 42 Entrepreneurs' relief: exclusion of goodwill on incorporation

Policy aim: Allow ER on incorporation by sales of a trade into a company where the vendor is retiring from the trade.
Problem identified: denies ER where the vendor is a sole trader or where the vendor is related to a participator in the purchaser company. For example, a father might want to sell his business to his son, so the son might set up a company to buy the father's trade. Or a father might want to retire from partnership with his son, so the son might set up a company to buy the partnership trade. In both cases, the definition of a retiring partner denies ER to the father.
Possible solutions

- Remove the requirement that the vendor of the trade be a partner in a partnership
- Remove the requirement that the parties be associated but only by virtue of being business partners.

An appendix is attached showing a rough draft of what the revised rule might look like.
Amendments to take effect from 3 December 2014

6. Finance Act 2015 section 42 Entrepreneurs' relief: exclusion of goodwill in certain circumstances - application to incorporations under section 162 TCGA 1992.

Policy aim: not relevant.
Problem identified: the FA 2015 changes highlight an inconsistency in the ER rules. A person can qualify for ER as a sole trader or as a partner in a trading partnership, as well as by owning shares in a trading company. But if a trade is incorporated (by whatever mechanism), the period before incorporation is not aggregated with the period after incorporation, so the shareholder has to hold the shares for at least 12 months before sale.
Possible solutions

- an amendment enabling the periods of business before and after incorporation to be aggregated so that, so long as the conditions for relief as either an unincorporated trade or personal company have been met throughout the 12 months prior to the share sale, the individual will not be denied ER on the disposal of his shares.

- a specific exclusion where a s162A election.

Amendment to take effect from 3 December 2014

Appendix – potential redraft of section 169LA TCGA 1992
Current provision

169LA Relevant business assets: goodwill transferred to a related party etc]

(1) Subsection (4) applies if—

(a) as part of a qualifying business disposal, a person ("P") disposes of goodwill directly or indirectly to a close company ("C"),

(b) at the time of the disposal, P is a related party in relation to C, and

(c) P is not a retiring partner.

…

(3) P is a retiring partner if the goodwill is goodwill in a business carried on, immediately before the disposal, by a partnership of which P is a member and at the time of the disposal—

(a) P is not, and no arrangements exist under which P could become, a participator in C or in a company that has control of, or holds a major interest in, C (a "relevant participator"),

(b) P is a related party in relation to C because P is an associate of one or more relevant participators, and

(c) P is only an associate of each of those relevant participators because they are also members of the partnership.

Proposed amendments to section 169LA

(1) Subsection (4) applies if—

(a) as part of a qualifying business disposal, a person ("P") disposes of goodwill directly or indirectly to a close company ("C"),

(b) at the time of the disposal, P is a related party in relation to C,

(c) P is not a retiring person and

(d) the disposal forms part of a scheme or arrangement of which the main purpose, or one of the main purposes, is the avoidance of liability to capital gains tax, corporation tax, income tax and or national insurance contributions**.**

…

(3) P is a retiring person if the goodwill is goodwill in a business carried on, immediately before the disposal, by P or by a partnership of which P is a member and at the time of the disposal either condition A or condition B is met—

(a) Condition A is that P is not, and no arrangements exist under which P could become, a participator in C or in a company that has control of, or holds a major interest in, C (a "relevant participator"),

(b) Condition B is that condition A is not met but P's participation in any such company as is mentioned in condition B is not a participation such that that company would be P's personal company as defined in section 169S(3) and no arrangements exist under which that company could become P's personal company.

Background
The legislation governing Associated Disposals is in Sections 169K and 169P, TCGA 1992.
In his Budget Speech on 18 March 2015, the Chancellor said "We will close loopholes to make sure Entrepreneurs' Relief is only available to those selling genuine stakes in businesses".

The Tax Information and Impact Note (TIIN) issued on the same day states, *inter alia*, that "This measure ensures that at least a 5% stake in the business must be disposed of by a claimant in order to benefit from ER on an associated disposal" and also that "This measure is not expected to impact on family formation, stability or breakdown".

Clause 41, Finance Bill 2015, which almost immediately, due to the General Election timetable and without any opportunity for debate or consultation, became Section 41, Finance Act 2015, included, without any prior or other form of announcement, wide-ranging conditions relating to "purchase arrangements" attached to the previously announced 5% thresholds.

Policy
The TIIN states that the policy intention of ER on associated disposals is "to encourage someone who is significantly withdrawing from a business to sell the personal assets being used to the buyer along with the business".

There is no requirement in Section 169K for the buyer of the personal asset to be the same as the acquirer of the stake in the business which is the subject of the "material disposal" and Section 41 does not seek to impose such a restriction. Indeed, the most common use of the associated disposal rules is in relation to sales to third parties. A typical example is when a farmer sells some land for development and links this to the introduction of another family member into the family farming partnership.

The Brief submitted by HMRC to the meeting of the HMRC Capital Taxes Liaison Group on 1 May 2015 (The Brief) states that the policy aim of Section 41 is to "prevent ER being due on disposals of privately-owned assets which have not been genuinely used in a business, or when the disposal is not accompanied by a meaningful withdrawal from the business". However, Section 41 does not seek to address the first part of that aim. Sections 169K(4) and 169P remain as originally enacted.

Mechanism for achieving "meaningful" withdrawal – the 5% threshold
Section 41 amends Sections 169K(1) and 169K(2) to require a "material disposal" to be of a least a 5% stake in the business. This is probably the least controversial part of the new legislation.

In the context of a company, the test is a transfer of at least 5% of the ordinary share capital of the claimant's personal company and 5% of the voting rights (or 5% of the company's securities). This test has the merits of simplicity and certainty.

In a partnership situation, the test is defined by Section 41 to be 5% of the partnership's assets, which is not the same as a 5% stake in the partnership as it disregards liabilities. What does 5% of the assets mean? Is it 5% of each and every asset in the balance sheet? Is it 5% of the totality of assets with less than 5% of some and more than 5% of others? Is it 5% of CGT chargeable assets? Is it 5% of fixed assets? This is a source of great uncertainty and there is no guidance in the legislation.

If a partnership is wound up, each partner receives the balance on his capital account (or combined capital and current account, however described in the accounts). So the balance on each partner's capital account at the balance sheet date represents each partner's stake in the partnership. So a transfer of an amount representing 5% of the total partnership capital from one

partner's capital/current account to that of another partner is a clear way of showing a transfer of a 5% stake in the partnership from a partner, who is reducing his stake, to another partner (either another existing partner or a newly-joining partner). Partnership changes often take place at an accounting date of the partnership so current figures for the capital account balances at the date of change will be available and the transfer can be shown on the face of the capital accounts. In the event of a partnership change in mid-year, the 5% can be calculated on the opening balances at the start of the accounting period.

This is a clear and unambiguous way to arrive at a 5% stake in the partnership. Condition A1, as defined in the new Section 169K(1A) introduced by Section 41(2) could be reworded as follows at line (a) :

"P's disposed of interest is at least a 5% interest in the partnership's capital representing the total of all assets and liabilities of the partnership which are shared by all of the partners in the partnership"

There has been some suggestion that "partnership's assets" for the purposes of the new Section 169K(1A)(a) should mean the partnership's chargeable assets. This could be meaningless in the context of associated disposals when all of the chargeable assets are held off balance sheet. As an example, consider a farming partnership where the only chargeable asset is land. If the land is held off balance sheet (which is why ER on associated disposals is relevant) there will be no partnership chargeable assets. How do you dispose of a 5% interest in nothing?

Another suggestion has been made that the 5% should represent a 5% reduction in the sharing ratio for capital profits. If there are no assets on the balance sheet capable of giving rise to capital profits, a change in the sharing ratio is meaningless. As an example, a farming partnership may have no fixed assets on its balance sheet. All of the land may be held privately off balance sheet by the partners, the partnership may own no machinery if they use contractors and it is accepted practice that there is no goodwill in a farming business.

The proposed amendment to the legislation highlighted above thus remains the only realistic definition of the 5% threshold for a material disposal.

Some concern has been expressed that a partner could have a partnership interest of less than 5% and thus be deprived of the opportunity to qualify for ER on an associated disposal. Much of this concern may derive from a confusion between partnership interest and income profit sharing percentage and the problem may not be as common as may be thought.

For example, in a family farming partnership of three generations, grandfather (the oldest generation) may take a small income profit share to reflect his reducing role in the physical farming activities, father (the middle generation) takes the largest income profit share as he takes on most of the work and his eldest son (the bottom generation) receives a relatively small income profit share to reflect his lack of experience. In that situation, grandfather's stake in the partnership is often higher than father's despite the disparity in income sharing. Grandfather's drawings are often very low as he has other income, such as pensions, to live on while father may need very large drawings as he will have a family to support including, usually, a lot of school fees to pay for his younger children. So father's capital/current account balance may be a lot lower than grandfather's.

The solution, which has been proposed to this concern, is to allow a stake of less than 5% to pass the 5% test if the whole of that stake is disposed of. This should cater for a final disposal where a partner, who has held a larger stake in the past, has been gradually reducing his interest.
The last clause in the highlighted proposed wording above is necessary to clarify the treatment of a common feature in the accounts of many family farming partnerships.

Land, which is regarded as personally held by individual partners, is nevertheless introduced onto the balance sheet of the partnership. The legal title for the land remains with the introducing partner who makes a declaration of trust to say that he is holding the land on trust for the partnership subject to the provisions of the partnership agreement. The partnership agreement will say that any capital profits arising from the introduced land are allocated 100% to the introducing partner and that the introducing partner (or his personal representatives) reserves the right to withdraw the introduced land *in specie* at any time, subject only to the other assets on the balance sheet being sufficient to cover the partnership's liabilities (or to the partner in question introducing other funds onto the balance sheet to make good any asset shortfall). The right to withdraw the land *in specie* also overrides the option given to other partners to acquire the partnership interest of a deceased or retiring partner.

Such introduced land is held in a special land capital account, along with any mortgage on it (so that the balance on the land capital account is the value of the partner's equity in the introduced land). This is separate from the general capital and current accounts, which summarise all other partnership assets and liabilities which are shared by all partners. Balances on the general capital and current accounts are capable of being transferred between partners but a balance on a land capital account cannot be so transferred.

The introduction of land onto the balance sheet in this way does not constitute a disposal for CGT by the introducing partner to the other partners and the land remains a personal asset for CGT purposes. This introduced land is then available to be farmed by all of the partners, it is available to be used as security for partnership borrowings and, in the event that this is needed, it qualifies for full IHT business property relief on any value in excess of the agricultural value on which full agricultural property relief is available. Treating the land in this way also gives the farmer the freedom to leave his land as he wishes in his will and thus make some provision for family members, usually daughters, who may not be involved in the farming business.

The transfer of a 5% partnership interest based on the general capital and current accounts but excluding the land capital accounts has already, on a previous occasion, been accepted by HMRC in an actual client situation as an acceptable material disposal to support an associated disposal. The HMRC spokesman has also indicated in a telephone conversation on Section 41 that this treatment is a reasonable interpretation of the 5% condition in Section 41.

The wording highlighted above thus appears to provide a solution to the 5% problem.

Anti-avoidance

Section 41 introduced, without prior announcement, the concept of "purchase arrangements" to restrict the situations in which 5% share disposals or 5% partnership disposals could be accepted as material disposals to support associated disposals. These measures are very wide-ranging, embracing all parties connected with the disposer of the material interest as well as the disposer himself, and discriminate severely, unfairly and without justification against family companies and family partnerships, while having no impact on businesses where the participators are unrelated.

The justification for this legislation set out in The Brief is that it aims to prevent a claimant from recovering the shares or assets disposed of. If the legislation were narrowly defined to cover just that situation, it would be less objectionable. It is the extension to all connected parties and all future arrangements which is unacceptable. What evidence does HMRC have that there is any widespread abuse along these lines? Isolated cases of abuse could be tackled by using the GAAR without the need for damaging legislation.

Normal transfers of shares between family members in a family company are thus deemed unacceptable. Even if shares are transferred to a non-family member, this will still be an unacceptable transfer because the pre-emption rights in the company's articles, which are

designed to keep shares within the family, will be deemed to be a "future arrangement". So perfectly normal, commercially justifiable, associated disposals of assets linked to harmless share transfers will be denied ER.

As an example, based on an actual client situation, consider a family farming company where the shares are held by father and mother. Their son has already become involved in the business and his parents believe that he is sufficiently involved to be given some shares and made a director. Both father and mother each give a 5% shareholding to their son. Father owns personally a small area of land of about 10 acres in the village. It is separate from the rest of the farm, being a left-over remnant from a much larger area most of which was sold in the past, and is non-core to the farming business. Indeed, it is a bit of a nuisance as it involves taking heavy machinery through the village to farm it, thus causing a lot of unpopular traffic holdups in the village. The land does not have planning permission for development but a local developer is prepared to take a long-term punt on the land and offers to buy it. Father is quite happy to get rid of it and sells it shortly after giving shares to his son. He claims ER on the land sale as an associated disposal. His claim was accepted as this happened a few years ago but, if it happened now, the claim would be refused because the share transfer was made to a connected person, who thus increased his shareholding. What is objectionable about the arrangements in this situation?

Normal succession arrangements within a family partnership are also deemed unacceptable. Indeed, The Brief goes so far as to express surprise that there should be such arrangements. "Apparently", it says "it is common" for family members to acquire a retiring partner's share. It then goes on to claim the moral high ground by saying that relief should not be due if an associated disposal is made to the same family member who acquires the partnership share (despite this being the fundamental policy aim of ER on associated disposals, as mentioned earlier) because the asset "plainly" remains in the family and it is "reasonable to infer" that the retired partner will somehow not have relinquished all beneficial ownership.

This reasoning bears no relationship to what goes on in the real world.

Succession is a continual process within most family farming partnerships with new young family members coming in at the bottom, the middle generation being the most active and the oldest generation slowly fading away – but rarely retiring completely until they die. Land tends to remain with the top generation until death. This protects it from the risk of a divorce in the middle generation. There is no IHT disadvantage to holding agricultural land until death. Also, at a time of rising farmland values, the CGT base cost uplift to probate value is very welcome.

It would be very rare for any land to be transferred down the generations during the lifetime of "grandpa" (as HMRC puts it in The Brief). If it did happen, it would be a gift and CGT holdover relief under Section 165 would be claimed so ER on an associated disposal would not be in point. There would be no sale down the generations as such a sale would generate an SDLT charge, which would be seen as unwelcome leakage from the family coffers. So the unacceptable associated disposal envisaged by HMRC in The Brief would hardly ever arise.

The vast majority of land sales by partners in family farming partnerships, giving rise to ER claims on associated disposals, will be to third parties. At a time when there is great political pressure for more houses to be built, some land may be sold for development. Some land may be lost by compulsory purchase for a road scheme or other public amenity. Other land, which has become non-core to the business may be sold to a neighbouring farmer. Small areas of land may be sold for pony paddocks. Such sales by non-family businesses would attract a 10% CGT rate if structured as associated disposals. Why should this facility be denied to family businesses?

The Brief doesn't appear to recognise that sales to third parties take place so it is not clear whether HMRC finds them to be objectionable or not. It is therefore not obvious whether HMRC did intend

to discriminate against family businesses by denying them ER on associated disposals to third parties, while preserving the relief for non-family businesses, or whether it has all happened by accident because ill-considered legislation was rushed through Parliament before the General Election.

In any event, the legislation on purchase arrangements in its current form needs to be repealed.
Settled as amended

Aparna Nathan
24 August 2015

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see icaew.com/en/technical/tax/tax-faculty/~/media/Files/Technical/Tax/Tax%20news/TaxGuides/TAXGUIDE-4-99-Towards-a-Better-tax-system.ashx)

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