Entrepreneurs' Relief and Goodwill – what did the Autumn Statement say?

6 July 2015

In this article we are going to take a closer look at the new rules which seek to restrict tax relief for goodwill when a business is sold. These restrictions were announced in last year's Autumn Statement, and have since become law, being incorporated into the first Finance Act of 2015. The new rules are aimed at individuals or partnerships who decide to incorporate their business. What is striking is that the new rules go further than the mischief that they are intended to counteract.

The new rules apply when an individual or firm transfers a business to a close company, and there is a connection between the company and the business owners (we shall see what this means later on). In these circumstances, both parties to the transaction are subject to restrictions on their tax relief:

- Firstly, for those individual owners eligible for CGT entrepreneurs relief ("ER"), the goodwill element of the business is excluded from the assets qualifying for the 10% rate. This part of the gain will be taxed at the higher 18%/28% rates instead;

- For the company seeking to claim tax relief as it writes down the goodwill in its accounts, there is a restriction on the amount it can claim. In the case of internally generated goodwill, no relief will be available until a sale takes place.

These rules apply to all business transfers taking place on or after 3 December 2014[1].

For CGT purposes, this refers to the date of the contract, rather than completion. For example, a contract made before this date isn't affected even though completion is delayed till after that date – for under the CGT rules, the date of the disposal is the date of the contract[2].

For corporation tax purposes, the rules are slightly different. Again, it is the date of the contract that is important, **BUT, the contract must have been completed before 3 December 2014 in order to be outside the scope of the new rules**. Where a transaction straddles this date, so that:

- The contract was made before 3 December 2014; but

- Completion is delayed until after this date,

the company's accounting period is split in two and the goodwill cost allocated accordingly. Tax relief is freely available for that part of the goodwill relating to the pre-3 December period, but restrictions will apply to the part relating to the post 3 December period[3].

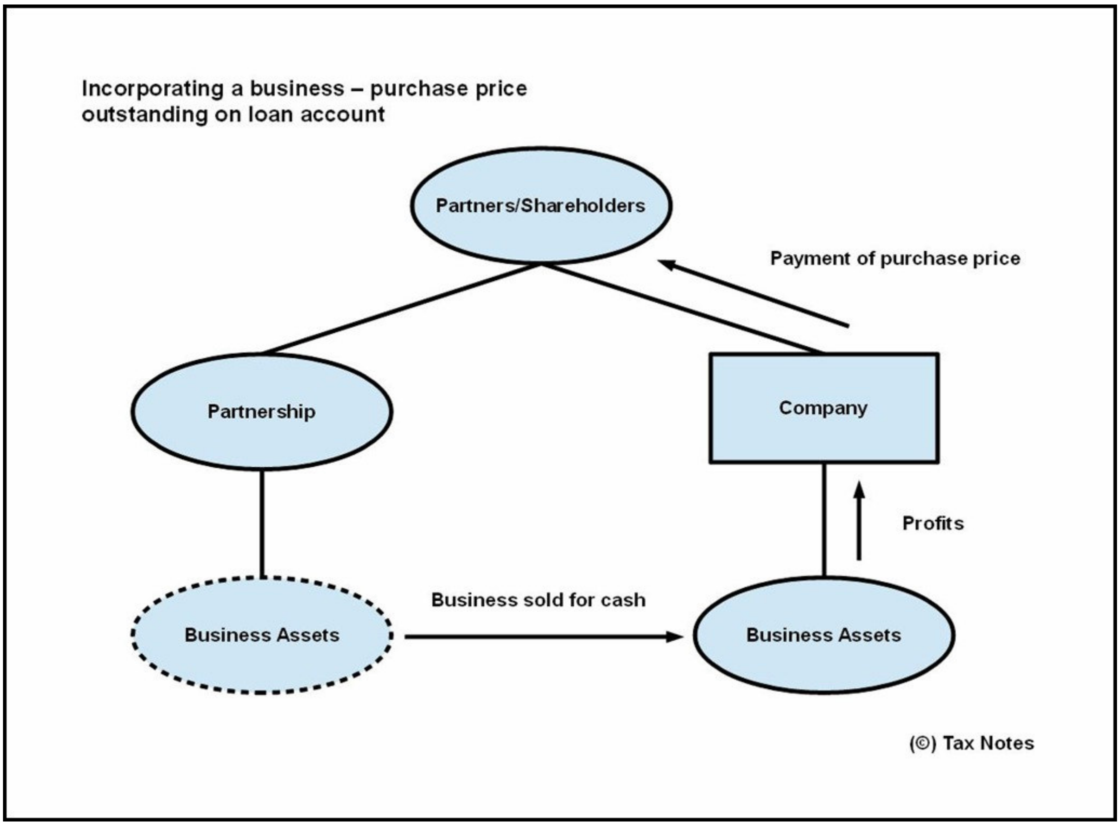
So let us now take a closer look at what these rules are intending to achieve.

What is the mischief that these new rules are trying to stop?

Although this is a curtailment of CGT and corporate reliefs, the new rules are really targeting a type of transaction that HMRC perceive as a device for income tax and NIC avoidance.

Where a business operates as a sole trader or partnership, the individuals are taxed on the business profits at rates that are substantially higher than the current corporation tax rates. Higher tax rates for individuals amount to 40-45% with an additional NIC charge on top, whereas the corporate rate is about 20%.

If only the business were run by a company…



This is how the business is incorporated to achieve a lower tax rate. In the following we shall assume that it is a partnership that is incorporating, but the same principles apply to a sole trader.

- First, incorporate a company whose shareholders are the partners – each partner holds shares in proportion to his share of the business;

- Sell the business to the company at its current market value. The company has no cash, so it leaves the purchase price outstanding on loan account;

- The sale of the business gives rise to a CGT charge. However, if the relevant conditions are satisfied, the owners are taxed at the lower 10% rate available for entrepreneurs (we shall assume all of them qualify – but this may not necessarily be the case)[4]. In particular, the 10% rate is available for any goodwill transferred as part of the business;

- The company then starts to operate the business, generating profits which are taxed at the lower corporate rates;

- These profits are then repatriated to the company's shareholders. But the company doesn't need to pay a dividend or salary which would attract further income tax and NIC – since it already owes money to the shareholders, it can simply pay off the loan instead. This is a tax free payment, which the owners can freely enjoy after first paying off their reduced CGT bill.

HMRC doesn't like this. And we shall now see what they've done about it.

Two key concepts – what is a close company and what does it mean to be related?

A close company is a company that is under the control of five or fewer participators[5]. A participator is someone with an economic interest in the company, normally a shareholder, but this need not be the case[6]. Furthermore, a person's interest can be aggregated with other people who are linked with him – his associates[7]. A number of different people can be an associate such as a brother or sister – but the most important type of associate for the purpose of this article, is a business partner[8].

The concept of being related is specific to the intangibles regime. In order for an individual to be related to the company, the following conditions are sufficient for the purpose of this article[9]:

- The person is a participator, such as a shareholder. It doesn't matter how large his stake is, and he doesn't even need to be one of the five who make the company close[10];

- Alternatively, he holds no shares or other interest in the company, but is an associate of a person who does have such an interest.

How is Entrepreneurs' Relief restricted?

As mentioned previously, the goodwill is excluded from the assets qualifying for the 10% rate[11]. If a substantial part of the business is made up of goodwill, this will hit the business owners very hard indeed.

These are the conditions for the new rules to apply[12]:

- A person must dispose of goodwill as part of a business sale to a close company; and

- At the time of the sale, that person is related to the company.

These conditions will always be satisfied in the scenario mentioned above. In particular, the company will always be close. This is clearly the case for a sole trader. But even in the case of a large partnership, the company will be close. The partners collectively constitute a single person controlling the company in question, since each individual partner's interest is deemed to include the interests of his fellow partners who are his associates.

Furthermore, each partner is related to the company by virtue of his shareholding.

What are the restrictions on corporation tax relief?

Under the intangibles rules, a company is permitted a tax deduction for goodwill and other intangibles in accordance with the accounting treatment. The proviso is that the goodwill is "new goodwill", created on or after 1 April 2002, or which has been acquired by the company from an unrelated party after that date.

First of all, note that the restrictions on tax relief go wider than just goodwill. The restrictions apply to the following assets, including any license related to such assets[13]:

- Goodwill;
- Customer lists and related information – customers includes potential customers as well as existing ones;
- Customer relationships;
- Unregistered trademarks, or other signs that are used in the business.

All the additional items have a common theme, which is that they are all closely related to the goodwill of a business. (For example, see what HMRC says about unregistered trademarks in their Manual at CG68210[14]). When discussing the company's tax relief, we shall use the term goodwill to include any of these additional items.

The restrictions apply when the company is close and either[15]:

- Where the person selling the asset is an individual, that person is related to the company; or
- Where the person selling the asset is a partnership, there is at least one partner who is related to the company.

And these cases clearly cover the scenario mentioned above.

As mentioned previously, the company would normally expect to claim tax relief as the goodwill is being written down in the accounts. But under the new rules, the relief is restricted:

- Where the goodwill was "brought in" by the business from an unconnected third party, the amount of tax relief that would normally be given in line with the accounting treatment is reduced by an appropriate multiplier[16];
- However, as far as internally generated goodwill is concerned, no tax relief is given for the accounting writedowns. Instead relief may be available when the business is actually sold. Even then any tax relief that may be available is regarded as a non-trading debit[17].

Let us illustrate this second scenario with an example.

Suppose that the company has acquired a business on incorporation, and the goodwill has been valued at £10m. Assume also that this cost is being amortised in the accounts at a rate of £1m per annum (this may or may not be an unrealistic figure, but it has been chosen to make the sums easier).

After three years, the company's accounts show the goodwill standing at £7m in the balance sheet, so in an ideal world, it should have obtained tax relief for £3m. But because of the new rules, this tax relief is denied. However, this doesn't prevent tax relief on a sale of the goodwill – the legislation states that[18]:

> "No debits are to be brought into account…for tax purposes…under Chapter 3 (debits in respect of intangible fixed assets.)"

And Chapter 3 is the part of the intangibles regime that deals with obtaining tax relief in line with the company's accounting treatment[19] – it doesn't apply to realisations – for example, a sale – which are dealt with in Chapter 4[20]. The new legislation goes on to states that[21]:

> "Any debit brought into account for tax purposes…under Chapter 4 (realisation of intangible fixed assets) is treated…as a non-trading debit."

Taking our example further, suppose the company sells the business and values the goodwill as £7m, the amount standing in the accounts. Can the company deduct the original cost of £10m and claim the lost tax relief?

The answer lies in CTA 2009 s 736 which applies when the company hasn't been claiming relief in line with the accounts. The amount to deduct is the cost of the asset recognised for tax purposes, which in turn is the amount of expenditure that has been capitalised in the accounts[22] – in short, this is the original £10m paid for the goodwill as required.

So the tax relief isn't totally denied – rather it is deferred until sale. However, this isn't a great result:

- First of all tax relief deferred is the equivalent of a cashflow cost;

- Secondly, the company has fewer options available for utilising the relief than would be the case if it is treated as a trading debit. For example, if the whole business is sold, a trading debit can be relieved against trading profits for the year, but if the result is a trading loss, this can be carried back for three years under the terminal loss rules[23]. However, non-trading debits can only be set-off against current year profits and surrendered to other group companies if any exist at the time of the sale[24].

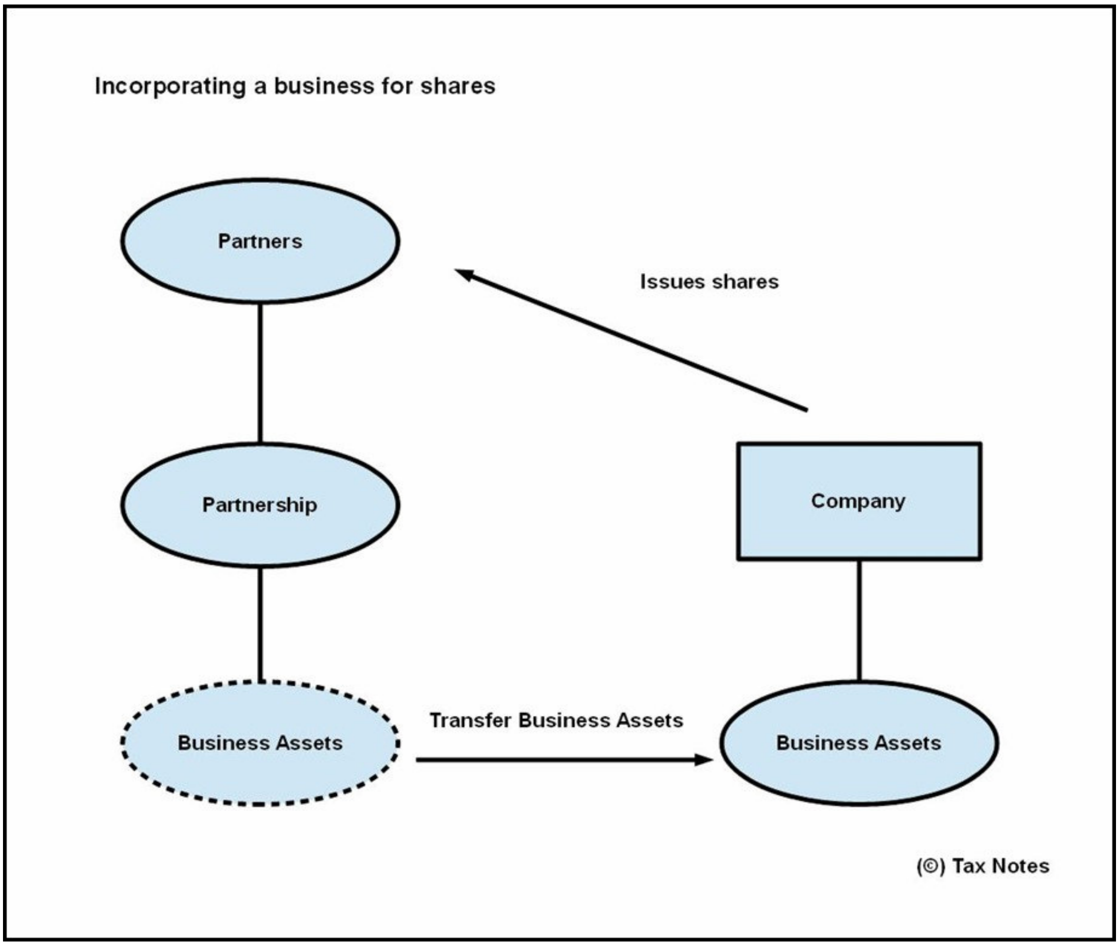
So what is the net effect of these new rules?

The effect of higher CGT rates together with the restriction of corporate tax relief, could lead to a significant reduction in the free cash available to the business owners. Incorporating the business in this way is no longer an attractive proposition.

Let us now look at a number of scenarios, where the extraction of cash isn't necessarily the main motivation behind transferring the business to a company.

What is the position when the business owners incorporate in return for shares?

In this situation, no cash consideration is involved – the company pays for the business by issuing shares to the owners. In these circumstances, the mischief that the new rules are intended to counter doesn't arise. Since the purchase price is no longer left outstanding, there is no loan to discharge. How can the company return money to the shareholders? A dividend or salary is taxable, and a loan from a close company is caught by the rules on loans to participators[25].



One would therefore expect this type of transaction to be outside the scope of the new rules. Unfortunately, this isn't completely the case.

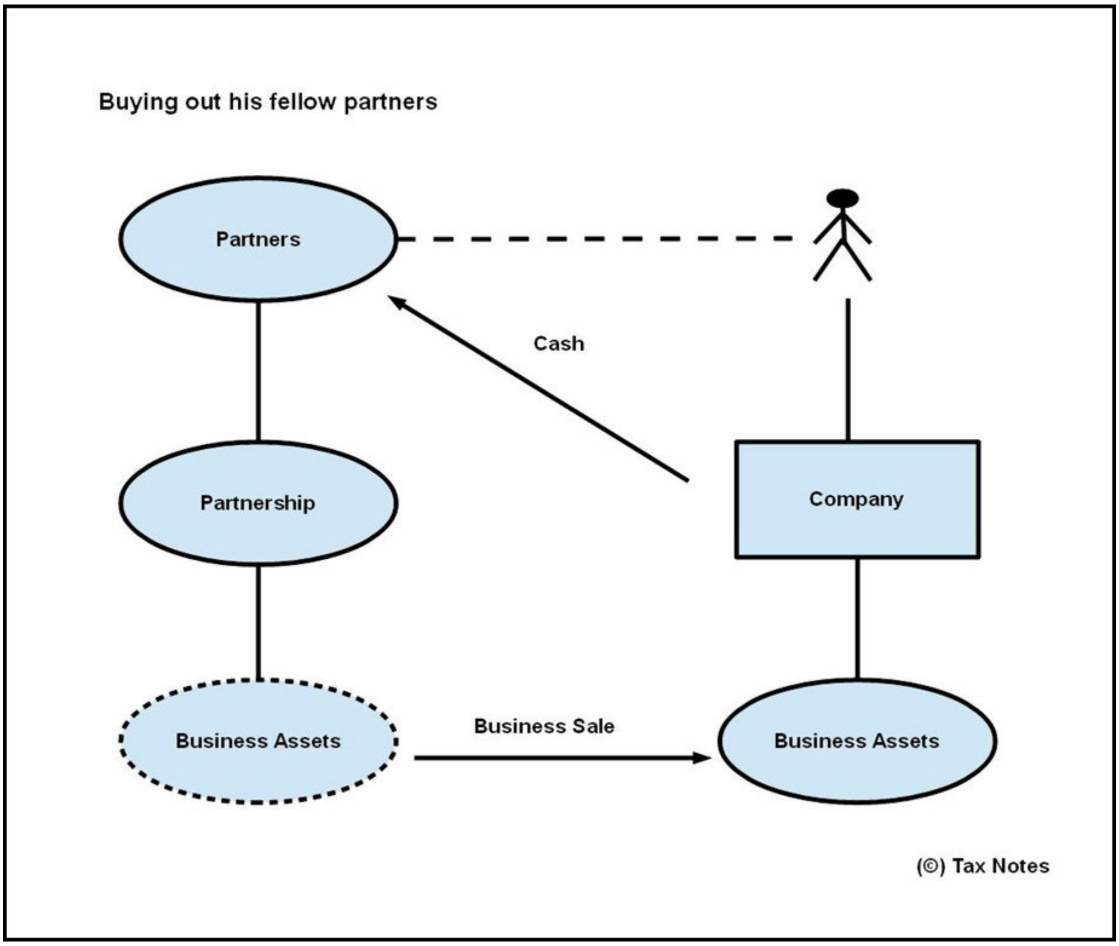
First note that this is a related party transaction, even if no shares are issued to the owners until after the business sale is completed. For to be a participator it is sufficient to be entitled to the shares[26], and this entitlement arises from very same contract under which the business is being sold[27]. In short, the business owners and the company are related *at the time of the sale*.

And this is a sufficient to restrict the company's tax relief on the goodwill. The legislation makes no distinction between this situation where the mischief doesn't arise, and the previous situation where it does.

However, the CGT position need not be affected. Entrepreneurs' relief isn't relevant, because normally, no taxable gain arises on a business incorporation[28]. This is because the gain is rolled over and deducted against the base cost of the shares, and only comes back into the charge when the shares are eventually sold. It is only at this later stage that the relief becomes relevant – but since this is a share sale, there is no scope in the legislation to exclude the value of the goodwill from the 10% rate.

What happens if one partner buys out all the others?

Consider the case of Mr P, who is planning to buy out all the other partners and run the business on his own. He incorporates his own company which pays cash in return for acquiring the business assets. Do the new rules affect this position?



Yes, they do! This is because each and every partner is related to the company:

- Mr P is related because he is a participator by virtue of his shareholding;
- All the other partners are related by virtue of being Mr P's partner at the time of the sale. Although they themselves have no interest in the company, they are regarded as Mr P's associates and it is by this association that they are related to the company.

Note what's happening. All but one of the partners is making a complete exit from the business. They aren't planning to indulge in any income tax/NIC avoidance – the cash sum they receive from the company is their exit payment, not a payment for continuing to be employed in the business.

And yet the exiting partners still have their entrepreneurs' relief restricted in respect of the business goodwill. It is ironic that this state of affairs has come about by virtue of being Mr P's partners at the point of sale – an association that will come to an end shortly afterwards when the partnership is wound up and they all go their separate ways.

The company's tax relief is also affected. And yet, unlike the previous two examples, this cannot be regarded as a case where there is no change in the economic ownership of the business.

Of course this situation doesn't arise if Mr P buys his partners out directly and then runs the business as a sole trader. There is no company involved, so entrepreneurs' relief wouldn't be impacted by this transaction.

But what would be the position if Mr P incorporates shortly after buying out his former partners? In theory, only Mr P's tax relief should be restricted, since he is the one transferring the business to the new company. His former partners have left the scene, so they ought to be safe – but could they still be caught by the anti-avoidance provision attached to the new rules?

This provision states that entrepreneurs' relief could still be restricted where the persons disposing of the goodwill – Mr P's former partners – are a party to "relevant avoidance arrangements"[29]. These are arrangements the main purpose, or one of the main purposes includes securing that[30]:

> "the person is not a related party…in relation to a company to which the disposal of the goodwill is directly or indirectly made."

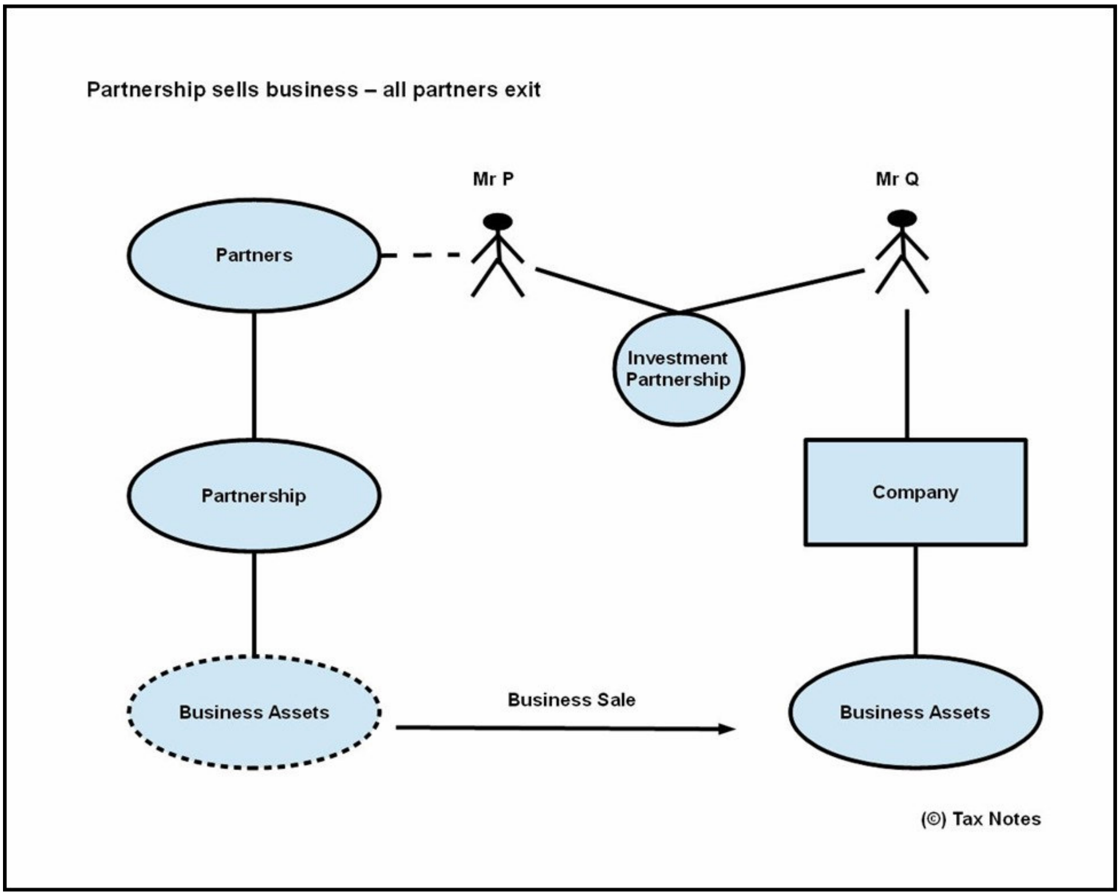
If the exiting partners have no idea of Mr P's plans to incorporate, this shouldn't be an issue. But what if they are aware of such plans, and decide to sell directly to him rather than his company? Can this be regarded as an indirect sale to the company?

Complete exit – all partners leaving

Consider the case where the business is being sold to a close company, whose shareholders are complete outsiders. None of them have any link with the exiting partners. Surely in this situation there can be no problem, either for the business owners or for the company acquiring the business. But consider the following scenario.

The partners are selling their business to a company controlled by Mr Q. Mr Q is a complete stranger to each and every one of the existing partners. He has never met them and he certainly hasn't met Mr P. They don't go to the same places, they have different interests, their paths have never crossed.

But there is one thing they do have in common – they have both invested their money in a property fund structured as a partnership with a substantial investor base. They are partners in a different partnership, and that makes them associates even though they have never had any previous business dealings with each other.



It is this link between Mr P and Mr Q that impacts the tax position of both Mr P and of Mr Q's company:

Mr P and the company are related because Mr P is an associate of Mr Q, a participator in the company. The association comes about entirely due to their both being members of a separate partnership which is totally unrelated to the business that is being sold;

The relation between Mr P and the company is also sufficient to restrict the latter's tax relief. In fact, as we shall see, Mr P is the only one of the original business owners related to the company – in other words, it only takes the presence of one person to spoil it all.

It may seem surprising at first that the other exiting partners are unaffected – for clearly, they are also linked to Mr Q, via Mr P. However:

- While they are associates of Mr P through the partnership that runs the business;

- They are not associates of Mr Q because a different partnership is involved, and none of them are members. It doesn't matter that Mr P is the common link – being associated with Mr P doesn't carry over into being an associate of Mr Q.

Accordingly, the other partners' tax relief will not be impacted and they can benefit from the 10% rate. Pity poor Mr P – his tax liability is increased simply because he happens to be linked to a complete stranger.

Note on statutory references

The new legislation amends the relevant parts of TCGA 1992 and CTA 2009 by inserting new sections. However, at the time of writing, the new tax books have yet to be published (Butterworths Yellow and Orange books or the CCH Red and Green). Consequently, practitioners will have to access the Finance Act 2015 to find the statutory references.

For the entrepreneurs relief rules, the new sections have been inserted by FA 2015 s 42, and for the new rules on goodwill have been inserted by FA 2015 s 26.

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[1] FA 2015 s 42(5), for entrepreneurs' relief and FA 2015 s 26(5) for goodwill restrictions.
[2] TCGA 1992 s 28.
[3] FA 2015 ss 26(5), (7).
[4] TCGA 1992 ss 169H, 169I.
[5] CTA 2010 s 439.
[6] CTA 2010 s 454.
[7] CTA 2010 s 451(4).
[8] CTA 2010 s 448.
[9] CTA 2009 s 835(5)(a).
[10] See the definition of participator in CTA 2010 s 454.
[11] TCGA 1992 s 169LA(3).
[12] TCGA 1992 ss 169LA(1), (2).
[13] CTA 2009 s 849B(2).
[14] http://www.hmrc.gov.uk/manuals/cgmanual/cg68210.htm
[15] CTA 2009 s 849B(1) – note that these particular words do not stipulate that the company must be close. However, this is the only way in which an individual can be related to the company in question by virtue of CTA 2010 s 835(5).
[16] CTA 2009 ss 849B(4), (5), 849C.
[17] CTA 2009 ss 849B(6), 849D.
[18] CTA 2009 s 849D(2).
[19] CTA 2009 s 726(1).
[20] CTA 2009 ss 726(2), 734.
[21] CTA 2009 s 849D(3).
[22] CTA 2009 ss 736(5), (6).
[23] CTA 2010 s 39.
[24] CTA 2009 s 753(1), CTA 2010 s 99(1)(e).
[25] CTA 2010 s 455.
[26] CTA 2010 s 454(2)(a).

[27] See the case of *HSP Planning HSP Financial Planning Ltd v HMRC* [2011] UKFTT 106 (TC) at http://www.bailii.org/uk/cases/UKFTT/TC/2011/TC00982.html and the Tax Notes article on incorporating goodwill at http://taxnotes.co.uk/incorporating-goodwill-can-you-claim-tax-relief-when-you-become-a-company) .

[28] TCGA 1992 s 162. However, under TCGA 1992 s 162A, one can elect for this provision not to apply – and then the relief *would* be relevant.

[29] TCGA 1992 s 169LA(5).

[30] TCGA 1992 s 169LA(6)(b).