

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 section 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.

The relief reduces gains by 4/9ths, resulting in an effective rate of 10% (5/9ths of the gain taxed at 18%).

- 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 total of £1 million.
 - The taxpayer is expected to keep a record of gains on which relief has been given.
 - HM Revenue and Customs (HMRC) will not keep such a record.
- Gains that exceed the £1 million limit are taxed in full at 18%.
- The relief is calculated before deduction of any allowable losses (other than any losses on assets that are part of the disposal of the business) and before the annual exemption.
- Trustees 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 (up to 5 April 2010, after which date there will no longer be any beneficial tax treatment 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:

- Has been a director or employee of the company, or of a company in the same 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 directorship 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 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.
- Investments in joint venture trading companies or under the corporate venturing scheme – a corporate equivalent of the Enterprise Investment Scheme (EIS) – 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 sells the shares and the property at the same time.
- 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 their interest in partnership assets at the same time.
- For an associated disposal to attract relief it must be part of the withdrawal of the asset's owner from participation in the business carried on by the company or partnership.
 - A partial sale of the business interest will not permit relief on an associated disposal.
 - A shareholder cannot claim relief on an associated disposal if they remain an employee or director of the company.
- 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 material disposal or cessation of the business.

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

- Where the asset was in use for the business for only part of the period of ownership.
- Where only part of the asset was in use for the purpose 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.
- 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, ignoring any rent 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.
- Anyone in this position might want to stop charging rent, or reduce the rent charged, so as to increase the entrepreneurs' relief that might be available on a later disposal. However, it may be difficult to predict whether such a disposal would satisfy the conditions for entrepreneurs' relief. And the rules may change before then.

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 (see page xx).

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

The gain after relief is then taxed at 18%.

If shares are exchanged for loan notes that are qualifying corporate bonds (QCBs), normally the chargeable gain 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.

Most loan notes are structured as QCBs.

Similarly, one can claim entrepreneurs' relief in calculating the gain to be deferred as a result of an investment in qualifying shares under the EIS (see page xx). Only the balance of the gain after 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.

Replacement of business assets

Rollover relief allows a person carrying on a trade to replace some fixed assets without having to pay CGT on any gain arising on the disposal of the old asset. 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.
 - Milk, potato or fish quotas, and ewe or suckler cow premium quotas.
- 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 (until 5 April 2010). The lettings must comply with a number of requirements, which are explained on page 1, "Property Letting".
 - Occupying commercial woodlands and managing them to make a profit.
 - Employment.
 - Providing an asset to a personal company. Here, 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 (until 5 April 2010) or commercial woodlands.
- Rollover relief is modified for 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.
- 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 a disposal of the shares.
- 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.

- Entrepreneurs' relief cannot be deducted from the gain to be rolled over. 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 in an unlisted trading company and large shareholdings (5% or more) in a listed 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.
- 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.)
- 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 qualify as business assets 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 Enterprise Investment Scheme

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.
 - The company, or its subsidiaries, must carry on a qualifying trade. Many asset-backed and some other trades are excluded.
- The deferred gain becomes chargeable on a disposal of 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, described on page 4, "Takeovers and reorganisations".
- If entrepreneurs' relief is claimed on the initial disposal (where that is after 5 April 2008), only the gain after entrepreneurs' relief is deferred.

Losses on new shares in unlisted companies

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

- Relief for the loss can be claimed against income for the year in which the loss was made or for the previous year.
- Claims must be made within one year from 31 January in the tax year following the loss, eg by 31 January 2012 for losses realised in 2009/10.
- For shares issued after 5 April 1998, relief is limited to companies that meet 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 £15 million immediately before and £16 million immediately after the issue of the shares, for shares issued before 6 April 2006, and £7 million before and £8 million after issue, for shares issued since 6 April 2006.

- 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 normally arise from a disposal of the shares at arm's length, or a liquidation or dissolution 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 year of assessment or of the preceding 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 18%, the 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 would not usually be available on the sale of the company B shares, as company B is unlikely to 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 of shares in company A, only the gain after relief is deferred.
- Sometimes the terms of the loan notes are deliberately structured in such a way that they are not QCBs.
- The CGT consequences are then similar to a sale in exchange for shares.
- Loan notes cannot themselves qualify for entrepreneurs' relief because they are not ordinary shares.

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.

Conclusion

A section of this length can only outline the special CGT rules that apply to owners of businesses. There are many other, often complex, aspects of the CGT reliefs for business owners that are not covered here. Further information can be obtained from the CGT pages on the HMRC website at www.hmrc.gov.uk/cgt/index.htm.

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 2009, which are subject to change.