

Potentially Helpful Changes to Entrepreneurs' Relief

Article By:

Charlotte Sallabank

Edward A. Tran

The UK Government has recently proposed further changes to the Entrepreneurs' Relief rules which could make it easier to obtain Entrepreneurs' Relief in certain cases.

Background

In October 2018, the UK Government sought to modify the existing Entrepreneurs' Relief rules by introducing a 5 percent economic ownership requirement that could result in some shareholders (in particular, management shareholders in private equity owned companies) ceasing to be eligible for Entrepreneurs' Relief when they dispose of their shares. The UK Government's latest proposal, which was introduced as an Amendment to the Finance Bill, sought to introduce an additional, alternative test for satisfying the 5 percent economic ownership requirement. This Amendment has now been included in the revised version of the Finance Bill (published on 9 January 2019).

Following publication of the first draft of the Finance Bill in October 2018, various professional bodies raised concerns with the UK tax authorities (HMRC) about how the two new tests that an individual would have to satisfy in order to meet the 5 percent economic ownership requirement for Entrepreneurs' Relief will operate in practice. The changes proposed in the first draft of the Finance Bill stipulated that in order to benefit from Entrepreneurs' Relief an individual shareholder must (at all times during the two years before sale) be entitled to at least 5 percent of both the company's distributable profits and its distributable assets on a winding-up, in addition to owning at least 5 percent of the nominal value of the company's ordinary share capital and being entitled to at least 5 percent of the voting rights, as is required under the current legislation. It should be noted that only a one year qualifying period would be required in respect of disposals prior to 6 April 2019. (Learn more about the proposed changes in Katten's 14 December 2018 advisory, "[Proposed Changes to Entrepreneurs' Relief](#)".)

Concern was expressed that these new economic ownership tests could result in shareholders ceasing to be eligible for Entrepreneurs' Relief, even though they were "true" economic owners. For example, in venture capital funded companies, founders could fail the 5 percent of distributable assets on a winding-up test because of the terms of a waterfall where, for example, the first part of the distribution is allocated in repayment of the price paid by the investor for his or her shares. So, a

later investor who had paid significantly more than a founder for his or her shares would have a bigger first call on the distributable assets, resulting in the founder potentially not meeting the 5 percent economic test. HMRC has considered listened to these concerns, and as a result have introduced an alternative test in an attempt to include "true" 5 percent economic owners within the relief but exclude those shareholders who are not.

Alternative Test for Entrepreneurs' Relief

The alternative test requires that a shareholder must be entitled to at least 5 percent of the proceeds in the event of a disposal of the whole of the company's ordinary share capital. When determining whether the 5 percent of proceeds test is met at any time in a period the following assumptions should be applied:

- 1. the whole of the ordinary share capital is disposed of at that time for a consideration equal to its market value on the final day of the period;**
- 2. the individual's share of proceeds is the amount that it is reasonable to expect the individual would have been beneficially entitled to at that time; and**
- 3. the effect of any avoidance arrangements is disregarded.**

The proposed legislation will be subject to anti-avoidance provisions. Arrangements will be "avoidance arrangements" if the main purpose or one of the main purposes of the arrangements is to secure that any provision of the Entrepreneurs' Relief legislation applies or does not apply and "arrangements" include any arrangement, agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable). This alternative test applies in respect of disposals on or after 21 December 2018 (the date on which the Amendment was tabled).

Whilst this alternative test may help in some circumstances, in many situations it will be difficult to satisfy. For example, in companies with several classes of shareholders whose entitlement to proceeds under the waterfall changes from time to time, depending on hurdles achieved, determining whether an individual would, on the assumptions, be entitled to 5 percent of proceeds on a disposal throughout the required two-year holding period may be difficult to determine.

Generally, however, whilst this alternative economic test will not necessarily be of significant assistance to all shareholders seeking eligibility for Entrepreneurs' Relief, it should remove some of the anomalies identified with respect to individuals who are true economic owners but who can fail under the entitlement to assets on a winding-up and distributable profits tests.

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