A conscious uncoupling

The withdrawal of capital gains tax entrepreneurs' relief on incorporation may have some hidden traps for partnerships, explains MEGAN BOURKE.

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No, you haven't accidentally picked up a celebrity gossip magazine and this is not yet another article about Gwyneth Paltrow's divorce. It may be about the end of partner relationships, but the business kind. The draft legislation dealing with the recent changes to capital gains tax entrepreneurs' relief in relation to goodwill contains a potential catch for those exiting partnerships, and this deserves a pause for thought. However, to keep the interest of the avid celebrity spotters among you, there are clues to various famous break-ups hidden (not very well) among the examples. Can you guess them all?

The prospect of incorporation

In 'Season of goodwill over' (*Taxation*, 22 January 2015, page 8) Iain Robertson was critical of the withdrawal of entrepreneurs' relief on goodwill acquired from related parties on incorporation and explored what may have been behind the policy decision. As a reminder, these changes were announced in the 2014 autumn statement and the draft legislation had effect from 3 December 2014. The amendments mean that, unless incorporation relief is claimed, the capital gains tax on incorporation is now payable at 28%, not 10%. This, combined with the withdrawal of amortisation relief for the company, makes incorporation less attractive after 3 December 2014 than it once was. However, with corporation tax rates significantly lower than the higher and additional rate personal tax bands, there are still savings to be made and many will continue to see incorporation as worthwhile.

The extra 18% capital gains tax payable might be considered to be worth it when set against future savings, but what if there are no future savings? What if the individual losing their entrepreneurs' relief is genuinely retiring from a business and ceasing to trade? And what if the increased capital gains tax liability has arisen due to a decision that someone else has made?

As is the case for both pre- and post-3 December 2014 incorporations, a partner exiting a partnership is eligible to claim entrepreneurs' relief on the disposal of their goodwill. For example, if Robbie wanted to leave the successful partnership that he was a member of, and if the other four partners were to buy him out, he would be able to claim entrepreneurs' relief on the disposal of his goodwill.

However, under the strict interpretation of the draft legislation, this could change if there is the prospect of incorporation.

KEY POINTS

- The draft legislation withdrawing entrepreneurs' relief for the transfer of goodwill on incorporation may have unexpected implications.
- A retiring partner can claim relief on the disposal of his share of goodwill.
- Problems may arise if taxpayers are associates.
- Delaying the incorporation may not solve the problem.
- HMRC say that their policy is not to deny relief to individuals who are genuinely retiring from a business.

Tom and Katie

As an example, Tom and Katie are in a business partnership and Tom is going to retire. Katie wants to carry on the business (because she is slightly younger) but wants to have the protection of limited liability now that she is to go it alone. She decides that as part of the transaction she will incorporate the business.

Because the incorporation and retirement happen simultaneously, Tom and Katie are still business partners at the time of his disposal. Under CTA 2010, s 448(1)(a) this makes them associates for the purposes of the new ***Draft Legislation*** to be inserted at TCGA 1992, s 169LA. If the pair are associates at the point of the transaction, it follows that Tom would be a related party of Katie's new company, Suri Limited, through CTA 2009, s 835(5). See ***Related Party***.

A logical response to this risk would be to ensure that all of the paperwork was drawn up to show that the partnership ceased before the goodwill is transferred. Therefore, if there was no business partner relationship between the two individuals at the point of the disposal, the partners would no longer be associated with each other.

Brad and Jennifer

Some readers may wonder whether one could simply go one step further and organise the incorporation to be a few days or perhaps a week later. Unfortunately, there is a further little "catch" in the draft legislation that throws doubt over the effectiveness of both of these options.

Let's say that Brad wants to leave the partnership that he is in with Jennifer to pursue other business interests. Jennifer wishes to incorporate the business into a new company, Rachel Limited, of which she owns 100% of the share capital so that she can offer enterprise management incentive share options to employees. This is a purely commercial decision because she wishes to incentivise them to stay and help her keep the business going once Brad has left.

> ***"There is a further little 'catch' in the draft legislation that throws doubt over the effectiveness of both of these options."***

Brad is concerned about being caught by the related party rules so persuades Jennifer to delay her incorporation by a week so that he can maintain his entitlement to entrepreneurs' relief on his disposal.

In this example the potential issue arises due to the following phrase in the draft legislation – "a person (P) disposes of goodwill directly or indirectly to a close company". Because the goodwill that Brad has sold to Jennifer will be transferred to Rachel Limited a week later, he has indirectly disposed of his goodwill to a close company and is therefore caught by the proposed wording of the statute.

A different approach

What if Jennifer, deciding to be a friend (sorry) to Brad, also delayed the formation of Rachel Limited until after Brad's retirement? Well, there are anti-avoidance provisions contained in the draft TCGA 1992, s 169LA(6).

Here, relevant avoidance arrangements are defined as "arrangements the main purpose, or one of the main purposes, of which is to secure:

DRAFT LEGISLATION

New TCGA 1992, s 169LA "Relevant business assets: goodwill transferred to a related party etc"

(1) Subsection (3) applies if:

(a) as part of a qualifying business disposal, a person ("P") disposes of goodwill directly or indirectly to a close company ("C"), and
(b) at the time of the disposal, P is a related party in relation to C.

(2) P is a related party in relation to C for the purposes of this section if P is a related party in relation to C for the purposes of Part 8 of CTA 2009 (intangible fixed assets) (see Chapter 12 of that Part (related parties) and, in particular, section 835(5) of that Act).

(3) For the purposes of this Chapter, the goodwill is not one of the relevant business assets comprised in the qualifying business disposal.

(4) If a company:

(a) is not resident in the United Kingdom; but
(b) would be a close company if it were resident in the United Kingdom;

the company is to be treated as being a close company for the purposes of this section (including for the purposes of determining whether a person is a related party in relation to the company for the purposes of this section).

(5) If a person:

(a) disposes of goodwill as part of a qualifying business disposal; and
(b) is party to relevant avoidance arrangements;

subsection (3) applies (if it would not otherwise do so).

(6) In subsection (5) "relevant avoidance arrangements" means arrangements the main purpose, or one of the main purposes, of which is to secure:

(a) that subsection (3) does not apply in relation to the goodwill; or
(b) that the person is not a related party (for whatever purposes) in relation to a company to which the disposal of goodwill is directly or indirectly made.

(7) In subsection (6) "arrangements" includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable).

Notes.
Explanatory notes at: www.lexisurl.com/kd9an

RELATED PARTY

(1) This section explains when a person ("A") is a "related party" in relation to a company ("B") for the purposes of this Part.
(5) A is a related party in relation to B if B is a close company and A is, or is an associate of:

(a) a participator in B; or
(b) a participator in a company that has control of, or holds a major interest in, B.

(a) that subsection (3) does not apply in relation to the goodwill; or
(b) that the person is not a related party (for whatever purposes) in relation to a company to which the disposal of goodwill is directly or indirectly made".

Clearly, the intentional delay of setting up a close company would be classed as an "arrangement" and, because this would be with the aim of claiming entrepreneurs' relief, the plan could fail. This implies that a partner who retires could be caught by the anti-avoidance provision if the continuing partner or partners have any intention to incorporate. What would count as an intention?

How far through the process would the individual(s) continuing in the business have had to go for these provisions to kick in?

HMRC's approach

In all of my examples I have been taking the strict interpretation of the draft legislation. Helpfully, HMRC included a contact at the foot of the explanatory note that accompanied the legislation so my colleague was able to put these concerns across to enquire after HMRC's interpretation.

The response confirmed that under s 169LA in its "current form" a retiring partner would indeed be a related party of the continuing partner's, or partners', close company where the business is transferred to the company at the time of the retirement.

However, the specialist was also reassuring: "it is not part of the policy underlying this measure to deny entrepreneurs' relief to individuals who are genuinely retiring from a business" and "the interpretation of the phrase 'directly or indirectly' in s 169LA(1)(a) and of the 'arrangements' provision in subsection (5) will take this into account".

No worries?

There must be nothing to worry about then; pretend that this article has not been read. But first take a step back and consider two questions:

- What is the policy behind this measure?
- Will HMRC always be so generous with their interpretation?

Iain Robertson pondered the first question in his article, asking "could part of the motive for the change be the growing costs of entrepreneurs' relief?"

The answer to the second question is even more uncertain, but we all know that HMRC are under increasing pressure to maximise tax revenues. Would an inspector really be able to resist the legislative ability to take an extra 18%?

However, the draft legislation is, after all, only draft. Indeed, in his response, the HMRC specialist used the phrase "in its current form" when referring to the legislation as well as closing his email with: "Thank you again for raising this point." Perhaps, even as I type, the new s 169LA is being rewritten to be clearer about the intentions in respect of exiting partners. For now, though, the draft legislation is all we have and, because it has been effective since 3 December 2014, it is the only reference point for incorporations undertaken before the final legislation is released.

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A cautious approach

In the meantime, and until there is greater certainty over the final wording, I would advise caution. If a client is undertaking a transaction that looks similar to the ones covered here, steps should be taken to structure the timing of said transaction in the best possible way.

In addition, and most importantly, clients should be made aware of the risks of HMRC taking a strict stance in the future. It is only a risk, not a certainty, and, as outlined above, HMRC have indicated that they would not seek to take the point. However, as with all new legislation, only time will tell how the statute will be dealt with in practice. My advice is that, until the final legislation is agreed and the implications for exiting partners are clearer, clients should follow Gwyneth's advice and "uncouple consciously".

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