Hidden danger

Although claims cannot be made until 2019, **KEVIN SLEVIN** warns advisers to be aware of investors' relief conditions and the interplay with entrepreneurs' relief.

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In 'Gains from investment' (*Taxation*, 8 April 2016, page 12), I highlighted the key features of the then new investors' relief, introduced by Finance Bill 2016 and which is now in TCGA 1992, s 169VA to s 169VY. Legislative references in this article are to that act unless stated otherwise. Investors' relief, which applies only to gains arising after 5 April 2019 on shares issued on or after 17 March 2016 (being shares subscribed for solely in cash), introduces a 10% rate of capital gains tax. As with entrepreneurs' relief, this reduced rate is subject to a lifetime limit of £10m but has a quite separate lifetime allowance from that provided under the former.

As the Finance Bill went through the parliamentary process some important refinements were announced, but here I want to explore just one of them. In the absence of any other relief, the disposal of shares in a trading company would usually be taxed at 20% so the maximum saving from a successful claim to investors' relief is £1m – in other words, 10% of £10m.

One of the key features highlighted in the 'Gains from investment' article concerned the many restrictions applicable. I explained that, among other things, investors' relief could apply only to gains on shares acquired by subscription by the investor (or their spouse or civil partner) and added: 'The investor must not be an officer or employee of the company in question and nor can any person connected with him be an officer or employee.'

This restriction – which applies throughout the share-holding period for the shares in question – was modified to exclude only 'relevant employees'. The true position is set out in s 169VB(2)(g) and s 169VW – the latter defining the term 'relevant employee'. The focus of this article is solely on the issue of unremunerated directors and should not be viewed as a broad-ranging comment on investors' relief. Such are the complexities of our simplified tax system, this should be viewed as a single-issue article rather than exhaustive coverage of the topic.

KEY POINTS

- Investors' relief applies to gains arising after 5 April 2019 on shares issued on or after 17 March 2016.
- The employment restriction applies to 'relevant employees' only.
- There are some exclusions from the term 'unremunerated'.
- The same shares can be eligible for investors' relief and entrepreneurs' relief.
- Low levels of remuneration can have a substantial adverse effect on eligibility to investors' relief.

Relevant employee

For this purpose, s 169VW defines a person as a 'relevant employee' in respect of the issuing company at any time in the 'relevant period' when he or she is an officer or employee of either the issuing company or of a company connected with it. In the case of shares held by an individual, the relevant period is the entire share-ownership period (see below in relation to shares held by the trustees of particular settlements). However, the definition of relevant employee is subject to an important proviso.

Under sub-s 169VW(3) if an individual is an unremunerated director of the issuing company (or of a connected company) throughout the share-holding period and at no time before the relevant period had they, or a person connected with them, been connected to that company, the fact that they hold that directorship does not make them a relevant employee in respect of the issuing company at that time. For these purposes 'director' has the extended definition found in CTA 2010, s 452. However, this is subject to the investor not having been involved in carrying on (whether on the person's own account or as a partner, director or employee) the whole or any part of the trade, business or profession carried on by the issuing company (or by a company connected with the issuing company).

The term 'unremunerated' is defined extensively in s 169VX and the various exclusions are self-explanatory. For example, a director may receive a payment or reimbursement of travelling or other expenses wholly, exclusively and necessarily incurred in the performance of their duties as a director and still be regarded as unremunerated.

Likewise, interest paid at no more than a reasonable commercial return on money lent to the issuing company should not present a problem on being unremunerated, and neither should dividends paid that do not exceed a normal return on the investment to which they relate. Rent for any property occupied by the issuing company (or a related person) which does not exceed a reasonable and commercial rent is also permitted.

Another point worth noting is that any necessary and reasonable payment for qualifying services provided to the issuing company (or a related person) in the course of a trade or profession carried on wholly or partly in the UK, and which is taken into account in calculating taxable profits, should not result in the loss of a director's unremunerated status.

An example, of this might be where a director is also a partner in a firm of accountants that provide tax advice to the issuing company.

Gains by trustees

Section 169VH introduces relief in respect of some gains by trustees for shares they have subscribed for on or after 17 March 2016 (wholly in cash).

Like entrepreneurs' relief, this measure does not give rise to an additional £10m of investors' relief. In effect, this simply allows some beneficiaries to assign their personal lifetime relief to the trustees. These provisions relating to trust gains also include an exclusion for relevant employees, but here the exclusion applies to the activities of the qualifying beneficiaries.

To be a qualifying beneficiary they must:

- have possessed an interest in possession in the settled property (comprising the shares in question) throughout the three years ending on the date of the share disposal; and
- not be a relevant employee at any time in this three-year period.

"Interest paid at no more than a reasonable commercial return on money lent to the issuing company should not present a problem."

Such a beneficiary will not be regarded as a relevant employee even though they are a director if unremunerated (as discussed above) throughout the aforementioned three-year period.

The position of trust gains is outside the scope of this article, but it is important to be aware of the different time periods over which the relevant employee test is to be applied; that is, the period of three years ending on the disposal date for trust gains compared with the entire share-holding period for gains arising to individuals.

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MARY

In April 2021 Mary realised a £25m gain on the disposal of ordinary shares in Little Lamb Ltd – a singleton trading company as defined by s 165A, which has as its sole activity the manufacture and sale of widgets. Her position is that:

- before subscribing for her shares in Little Lamb Ltd on 10 April 2016 she was not involved with or connected to the company or its business;
- she became an unremunerated director of Little Lamb Ltd on subscribing for 5% of the ordinary unquoted shares therein (without becoming an employee) and she remained so throughout, say, the 60-month share-holding period;
- throughout the period of at least one year ending the date of the share disposal, Little Lamb Ltd is not only a trading company as defined for entrepreneurs' relief purposes by s 169S(4A), but it is also Mary's personal company (as defined by s 169S(3)) for the same purposes.

Mary has owned the shares in Little Lamb Ltd for more than three years and throughout the share-ownership period she has been unremunerated.

On realising the £25m gain, let's assume Mary claims both entrepreneurs' relief and investors' relief. Accordingly, ignoring her annual exemption, Mary's gain becomes taxable as follows:

- £10m to be taxed at the entrepreneurs' relief rate of 10%;
- £10m to be taxed at the investors' relief rate of 10%; and
- £5m to be taxed at the 20% rate.

Had Mary's gain been just £15m she could have claimed either the maximum entrepreneurs' relief, treating the £5m balance of the gain as attracting investors' relief, or the maximum investors' relief, treating the £5m balance of the gain as attracting entrepreneurs' relief.

Her decision will no doubt be driven by looking at her other investments to establish what future gains are likely to arise and which of the two reliefs will be available. It would not be possible to claim, for example, £7m under entrepreneurs' relief and £8m under investors' relief.

In summary

Reverting to gains made by individuals, and to summarise to this point, it will be seen that an individual who holds an office of director that is unremunerated will not normally be regarded as a relevant employee and can, therefore, enjoy the 10% rate of capital gains tax under the investors' relief provisions – assuming all other requirements of the relief are satisfied.

Interaction with ER

Investors' relief is quite separate from entrepreneurs' relief (ER), but there is no specific interaction provision. Accordingly, given the similarity of the requirements of each relief (but not losing sight of the differences) it is possible that the same gain could attract relief under each of the two provisions. In these circumstances the obvious question centres on which of the two reliefs should be claimed in advance of the other. It is understood that HMRC officials agree with the view that if the qualifying conditions are met for both reliefs, it is entirely the investor's choice as to which relief to claim. HMRC also agrees that if the conditions of both reliefs are satisfied and the gain exceeds £10m, the taxpayer can enjoy both reliefs on the same disposal! The example of ***Mary*** illustrates this.

Does the client feel lucky?

Looking again at the example of ***Mary*** (and assuming a £30m gain is realised after a share-holding period of five years), let's now assume that she was remunerated – say at £10,000 a year – and that her tax adviser correctly advised her that this would not prejudice her entitlement to entrepreneurs' relief. Assume also that no one considered investors' relief at the time of investment.

With the benefit of hindsight, the decision to pay £10,000 a year – a total of £50,000 – has cost Mary £1m in tax because, by losing her unremunerated director status, she will have sacrificed her entitlement to investors' relief.

Having realised gross sale proceeds of £30m, Mary may think she has the funds to seek damages from her tax adviser. Of course, I am joking; no reasonable person would react like that – or would they? The nursery rhyme 'Mary, Mary quite contrary' could take on a whole new meaning with her advisers ending up unremunerated.

Proceed with caution

Investors' relief is relevant now, yet many advisers have devoted little time to understanding its niceties. Just because it is more than two years before the first gains can attract this relief does not excuse advisers from being mindful of the conditions and the possible impact of a director drawing a small amount of remuneration.

There is a plethora of tax provisions to consider – not least maximising relief for possible losses – when advising a client who is investing in a trading company, but do not lose sight of investors' relief.

Perhaps when advising any client on a share subscription in a trading company it might make sense to establish how optimistic they feel about the likely realisation of their investment. If they cannot rule out the likelihood of any capital gain exceeding £10m, the advice will necessarily differ from that applicable to smaller gains and will cost more in terms of professional fees. In particular, the advice should cover the inability to be remunerated. The chances are that advisers will be instructed to assume that any gain will be less than £10m, but they should get such instructions in writing. ■

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