Known unknowns

Following FA 2015, uncertainty surrounds the entrepreneurs' relief trading company status issue where a company acquires a minority shareholding in another one, explains **KEVIN SLEVIN**. But all is not lost.

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In the beginning, the capital gains tax entrepreneurs' relief legislation caused uncertainty for some shareholders. Now we have only to cope with specific known unknowns. Arguably, as explained below, FA 2015, s 43(1) and s 43(2) have not made things worse as regards this relief for most shareholders in companies that create genuine commercial structures to exploit the opportunities that their trade presents. Most of those who lose out will be shareholders in contrived vehicles, such as some so-called management companies, but there will be a detrimental effect to others as well.

To recap, among other things, entrepreneurs' relief is given when there is a material disposal of business assets and this can include a disposal of shares in a trading company or in the holding company of a trading group (TCGA 1992, s 169I(6)).

Setting the scene

Before 18 March 2015, special rules operated to determine whether a company was a "trading company" or the "holding company of a trading group" for the purposes of entrepreneurs' relief. The statutory definition was found in TCGA 1992, s 165A(1) to (13). These subsections were intended to address situations where it is necessary to determine whether a company was a trading company or the holding company of a trading group and, in particular, where either the company in question or one or more of its 51% subsidiaries possessed a minority stake in another company. Just how was this shareholding investment to be measured within the overall scheme of things?

The term "trading company" is defined by s 165A(3) as meaning "a company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities".

Similarly, "trading group" is defined in s 165A(8) as meaning a group of companies:

(a) one or more of whose members carry on trading activities; and
(b) the activities of whose members, taken together, do not include to a substantial extent activities other than trading activities.

What, then, is the position where a company possesses a non-controlling holding in another company? Before 18 March 2015, s 165A(7) and (12) together provided the answer in many sets of circumstances.

KEY POINTS

- FA 2015 removed some fixed rules that determined the treatment of a joint venture owned by a trading company or group for entrepreneurs' relief purposes.
- A summary of the old rules and conditions.
- An example of the rules that apply from 18 March 2015 and how they might apply in practice.
- The factors that might indicate the trading status of a company or group.
- The importance of considering the commercial and other reasons behind the acquisition of an interest in a joint venture.

The old rule

In brief, on or before 17 March 2015, s 165A(7) and (12) applied to transactions if a company (the investing company) possessed a shareholding of 10% or more in a joint venture company (as defined below). To determine whether the investing company was to be regarded as a trading company or trading group for any period:

- the holding of any shares or securities in a joint venture company was to be disregarded; and
- the company was to be treated as carrying on a proportion of the activities of the joint venture company equal to the proportion of ordinary share capital held in the joint venture company.

TRADECO LTD

TradeCo Ltd is a longstanding maker of high-specification lathes and was established by its two directors, George and Amy Jones, who each own 50% of the shares.

In 2005, Georges' siblings inherited a holding of shares in XYZ Ltd from a connected family estate. This holding, which comprised 15% of the issued shares, was valued at £200,000 for probate purposes. George's siblings would have preferred to have had cash rather than shares, but XYZ Ltd was not in a position to buy back its own shares and nor could George afford a cash purchase of them. However, TradeCo Ltd had cash reserves, so George agreed with the board of XYZ Co Ltd that the shares of the deceased could be transferred to TradeCo Ltd. George had great expectations of XYZ Co Ltd and thought £200,000 was a bargain price and his siblings were delighted to receive the cash. The remaining 85% of the issued shares was held by four individuals.

Although XYZ Ltd was a trading company, there was no trading connection of any kind between it and TradeCo Ltd.

George's expectations for the company proved well founded and the 15% holding of shares in XYZ Ltd is now worth £2m.

Also in 2005, George was keen to extend the overseas sales of TradeCo Ltd into Indonesia. His company had already made some small sales via a third-party, but George was keen to pursue something more significant. He contacted a company that represented a number of manufacturers and, after a few months' negotiations, it was agreed that this company and TradeCo Ltd would establish a 50:50 joint venture company (ABC Ltd) based in Jakarta. ABC Ltd was to act as a wholesaler of TradeCo Ltd's products and would operate a showroom facility.

ABC Ltd proved to be a great success and within three years it had formed a wholly-owned Malaysian subsidiary to expand its operations in the region. Further, ABC Ltd had begun selling, on a large scale, complementary products from other manufacturers and had become a valuable business.

On 15 April 2015, George and Amy disposed of their shares in TradeCo Ltd for £10m, each realising a substantial capital gain that they hope will attract the entrepreneurs' relief rate of 10%.

For this purpose, and to the surprise of many, a joint venture company was simply defined in TCGA 1992, Sch 7AC para 24 as a trading company or the holding company of a trading group where 75% or more of its ordinary share capital is held by no more than five persons.

The circumstances of the investment – for example the motives leading to the decision by the board of directors of the investing company to invest in the joint venture – were of no consequence. A minority investment made on an arm's length basis, where there was no common trading relationship nor any intentions to form such relationships could still be regarded as a "qualifying investment in a joint venture company". Note that this continues to be the case for holdover relief claims.

There were instances before 18 March 2015 when these special joint venture rules did not apply. For example, because an investment did not amount to the minimum requirement of 10% of the ordinary share capital or because the company invested in could not be shown to have met the five-person test. In such situations it was necessary to examine not only the nature of the investment and the amount of capital tied up in it, but also to take a broader perspective and examine the commercial reasons for making (and retaining) the minority shareholding in question. A detailed consideration of the facts, including the history of the investing company and the perceived benefits of having a minority shareholding in another company, had to be undertaken.

The new rule

For share disposals on or after 18 March 2015, all that s 43(1) and s 43(2) have combined to do is to change the rules so that, for the purposes of entrepreneurs' relief, s 165A(7) and (12) are disregarded and *all* minority investments held by companies in other companies are considered in the same way.

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For the avoidance of doubt, it is not correct to say that a minority investment in a genuine joint venture company is "bad news" from an entrepreneurs' relief standpoint. Yes, the deemed attribution of a proportion of the activities of the joint venture company to the investing company has been abolished, but all is not lost. As mentioned, some companies found their investments fell outside the joint venture rules and therefore their trading status (whether as a singleton company or the holding company of a group of companies) fell to be determined under first principles in any event. Arguably, all that FA 2015 has done here is to greatly increase the level of scrutiny to be applied to all minority investments – rather than just some of them. When considering a trading status issue, advisers must now explore the why and wherefore questions in every case where a minority investment is held.

The scenario in ***TradeCo Ltd*** may be simplistic, but it highlights the point at issue.

TradeCo Ltd analysis

In ***TradeCo Ltd***, the question is how each minority holding of shares should be taken into account when deciding whether it is correct to treat TradeCo Ltd as a trading company within s 165A(3) so that capital gains tax entrepreneurs' relief is available to George and Amy.

It will be noted that, had the sale taken place before 18 March 2015, both XYZ Ltd and ABC Ltd would have been regarded as qualifying joint venture companies. Not only would the value of each minority holding be ignored when evaluating the trading status of TradeCo Ltd, but the appropriate proportion (15% and 50% respectfully) of each company's activities would have been deemed to be activities of TradeCo Ltd.

From 18 March 2015, the outcome depends upon the precise facts of each situation. However, in ***TradeCo Ltd***, whereas the investment in ABC Ltd is clearly trade-related because it has a clear link to the product sales of TradeCo Ltd, the investment in XYZ Ltd is not connected with TradeCo Ltd's trading operations. Looking at matters in the round, the most likely outcome will be to treat the capital tied up in ABC Ltd shares as being part and parcel of the trading activities of TradeCo Ltd whereas the share value in XYZ Ltd will be viewed as something other than a trading activity. The question then to be addressed is whether the activity of continuing to hold the shares in XYZ Ltd should be considered "substantial" in relation to the overall activities undertaken by it.

An indication as to how HMRC will approach matters is best obtained from its own manuals. A starting point in the *Capital Gains Manual* is CG53113.

> "The word 'activities' is not defined in the statute but in this context is interpreted to mean what a company does. Activities will therefore include engaging in trading operations, *making and holding investments*, planning, holding meetings and so forth."

Clearly, therefore, to avoid prejudicing an entrepreneurs' relief claim, the possession of minority interests in other companies needs to be seen as much more than a passive function of the company.

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Paragraph CG64090 comments on the meaning of trading company and holding company of a trading group:

> "There is no simple formula to this but some, or all, of the following are among the measures or indicators that might be taken into account in reviewing a particular company's status. These indicators, adopted for entrepreneurs' relief, are the same as those used for the old taper relief and in the substantial shareholding exemption for corporation tax.
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> - Income from non-trading activities.
> - The asset base of the company.
> - Expenses incurred, or time spent, by officers and employees of the company in undertaking its activities.
> - The company's history.
> - The balance of indicators."

Weighing up the indicators

On the balance of indicators, HMRC's *Capital Gains Manual* at CG64090 goes on to state:

> "The indicators discussed should not be regarded as individual tests to which a 20% 'limit' applies. They are factors, or indicators, that may be useful in establishing whether there is substantial overall non-trading activity. It may be that some indicators point in one direction and others the opposite way. You should weigh up the relevance of each in the context of the individual case and judge the matter 'in the round' (see approach of the Special Commissioner in the inheritance tax case of *Farmer and another (exors of Farmer dec'd) v CIR* SpC 216). If you are unable to agree the status of a particular company for a period then the issue could be established only as a question of fact before the First-tier Tribunal."

Readers are recommended to study CG53116, which also approaches the trading status issue but uses slightly different wording. It is written from the standpoint of giving guidance in relation to the identical terms used in the substantial shareholding exemption (SSE). This paragraph, supplemented by CG53116a, CG53116b, CG53116c and CG53116d, gives further pointers on how HMRC caseworkers may approach matters. On taking a balanced view of the indicators, it reiterates the comments in CG64090 and concludes: "It is anticipated that such cases will be relatively rare."

The importance given to arriving at a conclusion having due regard to a "balance of the indicators" cannot be questioned. It follows the best authority available (the *Farmer* case) but the reality is that it is easier said than done. A minority holding of shares in a company totally unconnected with the trade of the company seeking trading company status will be more problematic than the situation created by a trade-linked investment.

Mindful of the above, what is the position in ***HoldCo Ltd***?

HoldCo Ltd analysis

HoldCo Ltd will be investing cash into a new trading vehicle which is not its subsidiary and does not sell any of the HoldCo group's products. How will such an arrangement be viewed by HMRC regarding its trading company status?

Previously, this arrangement would have been covered by the joint venture rules and would not have presented a problem when evaluating the status of HoldCo Ltd. However, under

HOLDCO LTD

HoldCo Ltd, the holding company of a group comprising four trading subsidiaries, invests surplus cash in a joint venture (JV Ltd).

As part of the arrangement, HoldCo Ltd subscribes for 50% of the issued share capital in JV Ltd and lends £100,000 working capital to it. This investment enables JV Ltd to start a new trading operation selling the products made by Products Co Ltd into the US and Canada, buying them at the normal wholesale price less 10%.

This activity is totally unconnected with anything carried on by the HoldCo Ltd group.

the new rules – and because of the lack of connection to the activities of the HoldCo Ltd group – the activity of investing in JV Ltd has the characteristics of an investment rather than a trading activity and is likely to be viewed accordingly by HMRC. What if, as well as lending money to JV Ltd, HoldCo Ltd provides marketing advice for its operations in the US? This could be done under a shareholders' agreement and would draw upon HoldCo Ltd's extensive experience, it having traded there for many years.

It would seem that, if HoldCo Ltd has agreed to make a significant charge for its advice and support, a link might be created to the trading activities. However, simply because HoldCo Ltd provides services to JV Ltd, would not automatically support the conclusion that the investment by HoldCo is directly linked to the trade of the HoldCo Ltd group? For example, whether such activities amount to more than just the nurturing of an investment will be decided on the facts of each case. Clearly, if part of the HoldCo Ltd group's trading activities included providing marketing advice to unconnected third parties this would be viewed more favourably than a situation in which there is no such business carried on within the group.

Dividends from joint ventures

What is the impact on the trading status question of a joint venture company that pays dividends to its shareholders? How is this "investment income" to be taken into account?

Broadly speaking, it is understood that where HMRC are happy that an investment in a joint venture company has clearly been driven by the desire to expand or develop trading activities carried on, such dividends can be treated as though they were "trading" for the purposes of the trading status tests. If the company in question would otherwise satisfy the requirements of s 165A(3) or s 165A(8) as being a trading company or the holding company of a trading group, the receipt of a dividend on such a minority holding of shares should not adversely affect the conclusion of HMRC's case workers considering such matters. This is unless the minority holding of shares is to be viewed as an investment activity quite separate from the trading activities.

By implication, dividends received on shares comprising minority interests in companies not having such a link to the trade of the company or group in question will have a negative impact on the issue of the trading status of the investing company.

The hassle factor

Abuse of the joint venture provisions has resulted in their removal as regards entrepreneurs' relief. It is fair to say that the provisions were not really needed where the minority holding of shares was held in a company which carried on a trade clearly linked to the trade carried on by the investor (or by one or more members of a group of which the investor was a member).

Arguably, the old provisions only assisted in situations where there was otherwise likely to be a problem in categorising the minority holding as being directly linked to the investor company's trade. It gave a rough and ready set of rules which applied regardless of any connection with the trading activities of the investor in the joint venture (or the activity of other group members). More to the point, the old rules saved a lot of hassle in genuine commercial situations.

> ***"It is not possible to proceed with total certainty where the trading status of the company under review needs to be established."***

We are now left in the position of knowing in advance of any share disposal that it is not possible to proceed with total certainty in any case where the trading status of the company under review needs to be established and the company in question has been reckless enough to take a minority shareholding in another one. Until the full position is examined in great detail the company's status will remain a known unknown.

Conclusion

On recognising minority shareholding situations, the adviser will need to alert their client and request instructions to drill down into the full facts that led to the acquisition of the shares in question. In some cases, it may be necessary to explore the carrying out of a demerger so that the shares in the joint venture company are no longer owned by the trading enterprise.

In most circumstances, the likelihood is that it will be obvious that the shares in the joint venture company were acquired (and continue to be held) for purposes directly linked to the principal trading activity of the company or group in question. That said, now might be a good time to review all corporate clients in situations similar to those described in this article. Certainly, FA 2015 will result in an increase in the number of companies seeking non-statutory business clearances (see HMRC's *Non-Statutory Business Clearance Guidance* at NBCG1200) when there is a sale of shares in the pipeline. Of course, another known unknown will be which clients are willing to pay advice and guidance in this area. ■

Kevin Slevin is an independent taxation consultant and specialist in entrepreneurs' relief consultancy. He is the author of *Slevin's Guide to Entrepreneurs' Relief* (now in its seventh print) which is published by Slevin Associates. He can be contacted at: Kevin@slevinassociates.co.uk.