

# Share dilutions

Using several practical examples, **Sofia Thomas** considers the operation of entrepreneurs' relief when shareholdings are diluted following the April 2019 legislative changes.

**F**inance Act 2019 brought in some additional conditions and changes to capital gains tax entrepreneurs' relief. Looking through these changes it seems that they have been implemented to try to reflect the true nature of entrepreneurship and remove some barriers that previous rules created inadvertently. In the most part, these changes appear more generous to genuine entrepreneurs – although I note the comments of Kevin Slevin in his article 'Pointless?' (*Taxation*, 2 May 2019, page 18).

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Some of the FA 2019 changes were covered by Pete Miller in 'Happy outcome' (*Taxation*, 24 January 2019, page 8) and the conditions for personal companies were discussed by Kevin Slevin in 'Not so funny' (*Taxation*, 21 November 2018, page 18). As a recap the changes were as follows.

- A tightening of the definition of a personal company for the purposes of a disposal of shares or securities. This applies to transactions that take place on or after 29 October 2018.

## Key points

- Several changes were made to the entrepreneurs' relief rules by FA 2019.
- A revised alternative 'economic test' can apply from 21 December 2018.
- Owners of 'alphabet shares' may gain from an alternative test that requires beneficial entitlement to at least 5% of sale proceeds.
- A preferential claim on sale proceeds may cast doubt on the entrepreneurs' relief entitlement of other shareholders.
- Entrepreneurs' relief can be crystallised if investment dilutes the shareholding to less than 5%.
- The tax on crystallised gains can be deferred until an eventual sale.



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- Protecting the entitlement to entrepreneurs' relief when there is a dilution of the individual's shareholding. This applies to share issues that take place on or after 6 April 2019.
- Increasing the minimum qualifying holding period from one year to two years. This applies to disposals that take place on or after 6 April 2019 (except when the business ceased before 29 October 2018).

This article is going to take a fictional company and run through how the new entrepreneurs' relief rules will work in practice by way of some examples, and particularly with regard to the first two points above. The company we will be following is called Tulips Ltd. It has four management shareholders: Danny, Raheem, Sarah and Rashmi. Their current proportionate shareholdings are:

Shareholder	A £1 ordinary voting shares
Danny	36%
Raheem	28%
Sarah	20%
Rashmi	16%
Total	100%

Tulips Ltd is a trading company and the shareholders have all worked for the company for more than two years (thus satisfying the third condition in the changes bulleted above). The value of the company is about £7.5m. The shareholders are thinking of selling the company or undertaking a funding round to generate more cash for the business. They are keen to understand how these possible actions will affect their entitlement to entrepreneurs' relief.

## Do nothing?

Perhaps the starting point is the position now if the shareholders do nothing.

First, we should establish whether the shareholders could claim entrepreneurs' relief today in the pre-sale or funding round situation.

Finance Act 2019 introduced two new economic tests. Shareholders are required only to meet one of these, which must be satisfied for the two-year period leading to an event such as a sale or share dilution.

### The economic tests

The original economic ownership test is written as the new TCGA 1992, s 169S(3)(c)(i). This requires the seller shareholder to be beneficially entitled to at least 5% of:

- the profits available for distribution to the company's equity holders; and
- the company's assets available for distribution to its equity holders on a winding-up.

For these purposes, the legislation applies a modified version of the 'economic ownership' conditions used for the corporation tax group relief rules in CTA 2010, Pt 5 ch 6.

The term 'equity holders' would typically cover:

- all the ordinary shareholders – which includes some types of preference shares, but excludes 'restricted preference shares'; and
- loan creditors – except most bank borrowing and other commercial loans (see TCGA 1992, s 160 to s 164).

Let's say that Tulips Ltd receives an offer of £7.5m to buy the company. Using the above first economic test, all the management shareholders would be entitled to entrepreneurs' relief as long as all other conditions have been met, because they meet the 5% requirement.

Our file note checklist would then be:

Shareholder	A £1 ordinary voting shares	Entitled to entrepreneurs' relief?
Danny	36%	✓
Raheem	28%	✓
Sarah	20%	✓
Rashmi	16%	✓
Total	100%	

Unfortunately, the original proposed 'economic interest' test created considerable uncertainty, especially for owner-managed companies with alphabet share structures. There was a justifiable view that many such arrangements would not qualify under this new test. (See the replies to the 'Readers' forum' question 'Alphabet conundrum' on directors' share arrangements and entrepreneurs' relief in *Taxation*, 29 November 2018, page 22.)

### A revised test

Fortunately, after consultation with the professional bodies, HMRC announced a revised alternative 'economic test' on 21 December 2018 although the 'original' economic test has not been removed or amended and can still be used in straightforward cases.

Therefore, for disposals taking place after 28 October 2018, shareholders must satisfy the 5% ordinary share capital and voting rights requirements (s 169S(3)(a) and (b)) and one of two 'economic interest' tests.

If Tulips Ltd was structured with alphabet shares, there is an argument that, under the first test in TCGA 1992,

s 169S(3)(c)(i) as outlined above, whether a particular class of shares receives a dividend is at the discretion of the directors. Unless the articles of association give a particular class of shares a right to dividends, nothing stops the directors from distributing all the profits to one class of share or another.

If Tulips Ltd had an alphabet share structure the possible checklist under the first economic test would be:

Shareholder	A £1 ordinary voting shares	B £1 ordinary voting shares	C £1 ordinary voting shares	Entitled to entrepreneurs' relief?
Danny	36%			✗
Raheem		28%		✗
Sarah		20%		✗
Rashmi			16%	✗

Consequently, if a company has an alphabet share structure, the second economic test (in s 169S(3)(c)(ii)) is more likely to be used. This alternative requires the individual in question to be beneficially entitled to at least 5% of the proceeds in the event of a disposal of the whole of the ordinary share capital of the company. It is intended to allow individuals to use their entitlement to sale proceeds as evidence of their economic interest in the company if entitlement to the profits and the net assets of the company cannot be demonstrated.

“After consultation, HMRC announced a revised alternative 'economic test'.”

Using the second economic test, we have a better outcome to our checklist.

Shareholder	A £1 ordinary voting shares	B £1 ordinary voting shares	C £1 ordinary voting shares	Entitled to entrepreneurs' relief?
Danny	36%			✓
Raheem		28%		✓
Sarah		20%		✓
Rashmi			16%	✓

So, one of the key elements to examine, when considering whether entrepreneurs' relief will apply on a sale using either test, is the potential sale structure of the company and the position of any investors.

We will now move back to the 'simpler' company structure where all the management shareholders have A ordinary shares. As mentioned, based on their shareholdings, Danny, Raheem, Sarah and Rashmi would (in principle) all qualify for entrepreneurs' relief under either of the economic tests.

### Investment and preferential claims

Let's say that Tulip Ltd has received an investment of £2.5m from Daffodil Ltd. In return, Daffodil Ltd has been issued with new shares which has diluted the shareholders' total holdings from 100% to 75%.

The management shareholders checked that their shareholding did not drop below 5% and are confident they would all remain entitled to entrepreneurs' relief on disposals of the shares and they would like their tax adviser to confirm this. The investment would have the following effect on the shareholding.

Shareholder	£1 A ordinary shares nom value £ 000s	£1 B ordinary voting nom value £ 000s	Ordinary and voting nom value %	Entitled to entrepreneurs' relief?
Daffodil Ltd		2,500	25%	
Danny	2,700		27%	✓
Raheem	2,100		21%	✓
Sarah	1,500		15%	✓
Rashmi	<u>1,200</u>		<u>12%</u>	✓
Total	<u>7,500</u>	<u>2,500</u>	<u>100%</u>	

As we can see, all the shareholders' holdings have been diluted from their original position, but they remain above 5%. So, at first glance, they would still be entitled to claim entrepreneurs' relief. However, Daffodil Ltd has a preferential claim for the first £7m of proceeds on a sale. The management shareholders may decide this is a price worth paying because the investment will enable the company to enhance its future growth prospects; for example, by registering a patent.

This is where advisers need to be particularly careful when advising on the new 5% tests. As this example shows, if there is a preferential claim, we may not be able to advise our clients on whether relief is available until we know the potential sale proceeds of the company.

There will be a different entrepreneurs' relief position for the management shareholders if Tulips Ltd is sold for £10m or £20m.

### Sale for £10m

If the company was sold for £10m, with Daffodil Ltd having a £7m preferential claim, the remaining sale proceeds divisible between the shareholders will be £3m. When determining whether entrepreneurs' relief would be available, we need to calculate whether the seller shareholder is beneficially entitled – under TCGA 1992, s 169S(3)(c)(i) – to at least:

- 5% of the profits available for distribution to the company's equity holders, and the company's assets available for distribution to its equity holders on a winding-up; or
- 5% of the proceeds in the event of a disposal of the whole of the ordinary share capital of the company.

We must calculate what each management shareholder is entitled to as a percentage of the whole company on sale.

Shareholders	% of relevant sale proceeds	Relevant sale proceeds £ 000s	% of total sale proceeds	Entitlement to entrepreneurs' relief
Danny	27%	810	8.10%	✓
Raheem	21%	630	6.30%	✓
Sarah	15%	450	4.50%	✗
Rashmi	<u>12%</u>	<u>360</u>	<u>3.60%</u>	✗
Total	<u>75%</u>	<u>2,250</u>	<u>22.50%</u>	

Looking at the 'percentage of total sale proceeds' column we can see that, under this scenario, Sarah and Rashmi would no longer be entitled to relief because their entitlement on sale is less than 5% of the total amount.

### Sale for £20m

Conversely, if the company was to be sold for £20m, the five shareholders would receive £13m after the preferential £7m had been paid to Daffodil Ltd. The 75% share (£9.75m) divisible between the four management shareholders is as follows.

Shareholders	% of relevant sale proceeds	Relevant sale proceeds £ 000s	% of total sale proceeds	Entitlement to entrepreneurs' relief
Danny	27%	3,510	17.55%	✓
Raheem	21%	2,730	13.65%	✓
Sarah	15%	1,950	9.75%	✓
Rashmi	<u>12%</u>	<u>1,560</u>	<u>7.80%</u>	✓
Total	<u>75%</u>	<u>9,750</u>	<u>48.75%</u>	

Using the same tests as before, the table above shows that if the sale price was £20m, all four management shareholders would remain entitled to entrepreneurs' relief.

This is an interesting planning point. We will now need to explain to clients that, even if after the investment they retain their 5% holding, a preferential claim on sale will potentially affect the availability of entrepreneurs' relief on a future sale of the company.

### Dilution of a shareholding

The above scenario looked at the position if Daffodil Ltd invested money into the company which did not dilute the shareholders holding below 5%. However, the company's preferential claim on a sale would potentially affect the entrepreneurs' relief claim of two of the management shareholders.

It is also common for private equity funding to create dilution problems for existing shareholders who are eligible for entrepreneurs' relief if the external investment dilutes their ownership percentage below 5%. Before 6 April 2019, individuals in those circumstances would cease to qualify for entrepreneurs' relief completely.

We will now consider the impact of Daffodil Ltd investing £60m into the company with no preferential claim on exit. The value of the company before the new investment remains at £7.5m. The revised shareholdings would be as follow.

Shareholder	£1 A ordinary shares nom value £ 000s	£1 B ordinary shares nom value £ 000s	Ordinary and voting shares %	Eligible to entrepreneurs' relief pre-6 April 2019
Daffodil Ltd		60,000	88.89%	
Danny	2,700		4.00%	✗
Raheem	2,100		3.11%	✗
Sarah	1,500		2.22%	✗
Rashmi	<u>1,200</u>		<u>1.78%</u>	✗
Total	<u>7,500</u>	<u>60,000</u>	<u>100%</u>	

## Crystallisation of relief

As we can see, if this had been done before April 2019, Danny, Raheem, Sarah and Rashmi would not be eligible to claim entrepreneurs' relief on a subsequent disposal of the shares.

However, FA 2019 now provides some assistance to these shareholders because, broadly, the changes allow shareholders to crystallise entrepreneurs' relief on chargeable gains that arise before external investment dilutes their ownership percentage below 5%. The opportunity to capture the relief arises immediately before the share issue is made. It is worth noting that the minority discounts that typically apply for fiscal share valuation purposes are switched off here.

This crystallisation is achieved by the individual making an irrevocable election to treat the shares as having been disposed of and reacquired immediately before the share issue. The deemed disposal takes place at market value of the shares at that date.

The election to make the notional disposal must be made by the first anniversary of the 31 January following the tax year of the share issue (in other words, by 31 January 2022 for notional disposals in 2019-20). The election to defer the notional gain must be made within four years of the end of the tax year in which the gain arises (so by 5 April 2024 for notional disposals in 2019-20).

Looking at the previous summary using the post-6 April 2019 rules, the shareholders' entitlement changes and all the management shareholders are entitled to elect to crystallise the gain with entrepreneurs' relief immediately before the dilution.

Shareholder	£1 A ordinary shares nom value £ 000s	£1 B ordinary shares nom value £ 000s	Ordinary and voting shares	Eligible to claim entrepreneurs' relief
Daffodil Ltd		60,000	88.89%	
Danny	2,700		4.00%	✓
Raheem	2,100		3.11%	✓
Sarah	1,500		2.22%	✓
Rashmi	1,200		1.78%	✓
Total	7,500	60,000	100%	

The value of the company before the equity funding round was £7.5m. After the funding round when £60m was invested into the company, all of the management shareholders will drop below 5% ordinary share capital holding.

## Capturing the gains

If the shareholders want to retain their entrepreneurs' relief entitlement they will make a TCGA 1992, s 169SC election. This relief applies only on share issues undertaken for genuine commercial reasons and when the shares are issued wholly for cash consideration. The capital gains will be captured as follows.

### Planning point

Before electing to defer a capital gains tax liability under TCGA 1992, s 169SD, check whether the other entrepreneurs' relief conditions are likely to be met on a later eventual disposal.

Shareholders	Danny	Raheem	Sarah	Rashmi
% of £7.5m deemed sale	36%	28%	20%	16%
	£ 000s	£ 000s	£ 000s	£ 000s
Deemed sale proceeds	2,700	2,100	1,500	1,200
Less: Negligible base cost	-	-	-	-
Capital gain	2,700	2,100	1,500	1,200
Capital gains tax @ 10%	270	210	150	120

The gains will be taxable at the entrepreneurs' relief rate of 10% assuming they have enough of their lifetime allowance remaining. However, paying tax at 10% on a deemed disposal is usually undesirable because a dilution of their holdings does not give rise to any cash realisation – known as a dry tax charge.

Fortunately, as intimated above, a new provision, TCGA 1992, s 169SD, allows shareholders to make an irrevocable supplementary election that enables them to defer taxing their qualifying entrepreneurs' relieved gain until a later actual disposal of the relevant shares. It should be noted, however, that this deferral election does not remove the requirement to meet the other conditions for entrepreneurs' relief on the final disposal, it simply allows the 5% personal company test to be regarded as met on the final disposal.

So if, for example, Rashmi was planning to leave the company in a year before the final disposal she should consider the possibility of paying the tax charge before dilution at 10% rather than on a subsequent disposal when the gain would likely be taxed at 20% because she would no longer meet the officer of the company test.

## Summary

To summarise, advisers and their clients should remember the following points.

First, if investors have a preferential claim on exit it may not be possible to advise on their entrepreneurs' relief eligibility until a proposed sale price has been agreed. Second, if there is a dilution of shareholdings through investment, the shareholders may be able to capture the gain and defer this until the final disposal of the shares. However, third, it is critical to advise them that the deferral applies only to the 5% economic test conditions; all the other conditions must continue to be being met on the final disposal for entrepreneurs' relief to apply. ●

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