

# PRACTICE UPDATE

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## 1. Entrepreneurs' Relief

IT MAY HAVE BEEN AN AFTER-THOUGHT by the Government, but Entrepreneurs' relief is still better than no CGT relief at all.

### New relief, old problem

A new relief normally involves having to learn a whole new set of rules. However, entrepreneurs' relief is modeled around retirement relief, which was abolished in 2003. Unfortunately, some of the old problems associated with retirement relief have been resurrected in the new relief.

In particular, entrepreneurs' relief applies to a "material disposal of business assets", which is defined as including "a disposal of the whole or part of a business". But what constitutes a disposal of the whole or part of a business? A number of cases reached the Courts in the days of retirement relief on whether the disposal of a particular asset represented the disposal of the whole or part of a business. Those cases are likely to be relevant to entrepreneurs' relief as well. For example:

- The sale by a farmer of 4.8 acres out of 35 acres was held not to be a disposal of part of his business (*McGregor v Adcock*);
- The sale of 9 out of 89 acres of farmland was denied retirement relief for a similar reason (*Atkinson v Dancer*);
- A taxpayer sold his business premises, which was leased back to him. He sold the business 9 months later. The Court held that the sale of the premises could not be treated as part of the later sale of the business (*Purves v Harrison*).

As the circumstances of each particular case will vary, it seems very unlikely that HMRC will issue definitive guidance on what constitutes the disposal of the whole or part of a business. Advisers may therefore be forced to 'dust down' the old retirement relief cases for some assistance.

### Order of relief

The way in which entrepreneurs' relief interacts with other forms of CGT relief may be relevant in certain situations (e.g. a business sale at undervalue to a company upon incorporation, where holdover relief is claimed). HMRC's CGT Policy Unit recently indicated that the order of relief will be as follows, although this point has yet to be confirmed in official guidance:

1. Rollover relief;
2. Incorporation relief (TCGA 192, s 162);
3. Holdover relief (s 165);
4. Entrepreneurs' relief; and
5. EIS deferral relief

The most appropriate category, as well as the timing and amount of CGT relief, will require careful thought and planning in some cases (e.g. whether to 'bank' entrepreneurs' relief now or on a future disposal).

### New problems

In addition to the old problems previously associated with retirement relief as mentioned earlier, entrepreneurs' relief gives rise to new difficulties compared with the previous CGT taper relief regime. For example:

- Enterprise Management Incentive (EMI) shares and options – for taper relief purposes, the share ownership period

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commenced when qualifying EMI options were granted. Unfortunately, the draft entrepreneurs' relief legislation does not include a similar rule. The 12 month minimum holding period for the new relief therefore begins when the EMI option is exercised. This is likely to cause practical difficulties, because EMI options are often exercised when an employee leaves the employment, thus making it impossible to qualify for entrepreneurs' relief as the Finance Bill provisions originally stand.

- The 5% minimum holding requirement (i.e. share capital and voting rights) for shares means that many employees of larger trading companies (or holding companies of trading groups) in particular will not qualify for the new relief. This is in stark contrast to the taper relief regime, whereby (from 6 April 2000 until its abolition on 5 April 2008) *any* holding of shares in unquoted trading companies potentially qualified.

Other pitfalls and planning opportunities will no doubt arise over time concerning entrepreneurs' relief. Please contact me if you need any assistance regarding the new relief.

## 2. HMRC...only trying to help!

HMRC ARE NOT PERHAPS BEST KNOWN for their co-operative and helpful approach when dealing with professional firms acting as agents. However, two recent service improvements by HMRC will potentially make life easier for agents in the future.

### Customer Relations Managers (CRMs)

Agents in certain areas of the UK (e.g. Manchester and Liverpool) have access to a dedicated Agent CRM.

HMRC say that "This new service is a point of contact for when it is not possible to resolve problems through the usual routes. It is very much a concierge role, helping agents to get the assistance you occasionally need – signposting you to the right part of the Department or website, for example".

I recently attended a 'Working Together' meeting in Manchester, in which an agent was complaining about communication difficulties with HMRC in connection with a particular client. The Agent CRM who was present

promised to deal with the problem personally and resolve the issue.

Those Agents in areas supported by a CRM could do worse than to make use of this new service. For contact details, visit: [www.hmrc.gov.uk/workingtogether/news/crm-news.htm](http://www.hmrc.gov.uk/workingtogether/news/crm-news.htm)

### Business clearance service

A clearance service is now available for business clients. Firms can now approach HMRC by email or post for clearance on the application of the tax law to client business transactions or events. Clearance applications can be either pre-transaction (where evidence is supplied that the transaction is seriously being considered) or post-transaction. HMRC state that there must be "material uncertainty" about the transaction or event, and that the issue must be "commercially significant". There are limitations to the new clearance service. For example:

- It does not replace the statutory clearance procedure, on such matters as a company purchase of own shares or the 'transactions in securities' anti-avoidance rules. However, it is possible to make statutory and non-statutory clearance application in respect of different aspects of the same transaction or event.
- It only applies to business tax issues, so is not available on personal tax matters for individuals (e.g. the IHT implications of a transaction). However, there is already an existing procedure for clearance applications by individuals under HMRC's Code of Practice 10 ('Information and Advice'), available via HMRC's website: <http://www.hmrc.gov.uk/pdfs/cop10.htm>. VAT clearances are dealt with in VAT Notice 700-6.
- Not surprisingly, HMRC will not accept clearance applications about tax planning arrangements, or if an enquiry has already been opened into a tax return affected by the transaction.

### Be careful!

Whilst a service that provides firms and clients with certainty on the tax treatment of transactions or events is on the whole a good thing, there is a potential downside. No right of appeal generally exists against the view or

position taken by HMRC in response to a clearance application. So firms who submit clearance applications expecting or hoping for particular tax treatment, only to find that HMRC take a different (and possibly less favourable) view, may find that there is no recourse against HMRC's decision if they disagree with it. As with any clearance or approval process, if clearance is given HMRC cannot be bound by their decision upon unless the firm or client has made a full and complete and correct disclosure of all material events in the application (even then, HMRC state that if an incorrect clearance is given "...there may be some circumstances when we would not be bound by the advice we have given"). It is therefore vitally important that clearance applications are properly drafted. HMRC provide guidance on the format and content of clearance applications on their website ([www.hmrc.gov.uk/cap/links-dec07.htm](http://www.hmrc.gov.uk/cap/links-dec07.htm)).

### Business Property Relief (BPR)

In addition to the above general clearance service for businesses, there is a pilot clearance service specifically for IHT BPR related issues from 1 May 2008, for a trial period of six months. Clearances will be provided to business owners (and agents) on the availability of BPR if there is material uncertainty over the interpretation of the law. For IHT legislation older than the last four Finance Acts, there is a further requirement that the uncertainty relates to a "commercially significant issue".

Should you need assistance drafting a statutory clearance application, or a new non-statutory business clearance application, please do not hesitate to contact me.

### 3. Share and share alike!

SHARE TRANSACTIONS SUCH AS a company purchase of its own shares or a company sale for consideration which includes loan notes commonly involve applications to HMRC for advance clearance (under ITA 2007, s 701), that the 'transactions in securities' anti-avoidance rules do not apply. The rules are in ITA 2007, Part 13, Chapter 1 (previously ICTA 1988, ss 701-709). However, in what circumstances could those provisions apply?

The rules generally apply if:

- In one of five specific circumstances (see below) and
  - In consequence of a transaction in securities (or the combined effect of two or more of them),
- a person obtains (or is in a position to obtain) a tax advantage (ITA 2007, s 684).

However, the transaction(s) is not 'caught' if:

- it took place for genuine commercial reasons (or in the ordinary course of making or managing investments); and
- obtaining an income tax advantage is not a main object of the transaction(s) (s 685).

The five specific situations mentioned in the legislation are referred to as Circumstances A to E. Most owner-managed and family companies are closely controlled (or 'close') companies, and there are special rules to deal with them, referred to in the legislation as 'Circumstance D' and 'Circumstance E' (nb Circumstances A to C are less common in practice, and apply to dividend stripping and bond washing).

### Circumstance 'D' and 'E'

Circumstance D very broadly applies where:

- a person receives **consideration** (i.e. from the distribution, realisation or transfer of a relevant company's assets, or applying assets to discharge liabilities);
- the consideration reflects the value of **distributable assets** or **future receipts** or **trading stock** of the company; and
- the consideration is such that there is no **income tax** liability in respect of it.

However, the repayment of amounts originally subscribed for the shares is not caught (ITA 2007, s 689). Nevertheless, the rules are widely drafted. HMRC will often use case law (*Cleary v CIR*) to support their view the Circumstance D applies if, for example, a controlling shareholder in company A sells his shares to company B, which he also controls.

Circumstance E very broadly applies where:

- a person receives **consideration** (i.e. from a direct or indirect transfer of assets from one relevant company to another, or any transaction in securities involving two or more relevant companies);
- the consideration reflects the value of **distributable assets** or **trading stock** of a relevant company; and

- the consideration consists of **shares** or **securities** issued by a relevant company.

This rule is intended to catch the subsequent repayment of (non-redeemable) share capital, including distributions in a winding up or dissolution of the company (ITA 2007, s 690).

HMRC often use case law to support an argument that the 'transactions in securities' rules apply in situations involving the liquidation or winding up of a company. Those cases include *CIR v Joiner* and *Addy v CIR*. However, in another case, *Laird Group plc v CIR*, it was held that declaring a dividend was not caught. In the House of Lords, Lord Millett said that whether the company is in liquidation or continuing to carry on business as a going concern, the distribution of undistributed profits to company shareholders merely gives effect to the rights attaching to the shares. In addition, in *CIR v Joiner*, the Court held that the liquidation of a company cannot *of itself* be regarded as a transaction in securities.

This is clearly a difficult area of tax law. Firms can (and generally should) apply to HMRC for advance clearance that the transactions in securities rules do not apply, where appropriate. Please contact me if you are unsure about whether the rules could apply in individual cases, or for assistance in drafting clearance applications to HMRC.

#### 4. Goodwill – when to claim...

ONE OR TWO PRACTICES have recently asked for confirmation regarding tax relief claims for goodwill following the incorporation of a business. The tax treatment of intangible fixed assets for companies was introduced in Finance Act 2002, Schedule 29.

The effect of these rules is broadly to treat specified intangible assets of companies in a similar way to the normal trading rules. In the case of business incorporations, the most common form of intangible asset is goodwill. If the intangible fixed asset rules apply, the company may obtain a deduction for expenditure (generally spread over the asset's useful life) although disposal proceeds are treated as taxable. However, HMRC may challenge tax relief claims for purchased goodwill, etc where its value appears to be excessive. In addition, there are anti-avoidance rules to prevent the perceived abuse of the intangibles rules.

The intangible fixed assets legislation includes transitional rules to prohibit relief in respect of expenditure on transactions between related parties (FA 2002, Sch 29, paras 95, 118). Under the previous tax regime, goodwill fell within the capital gains rules, which meant that the cost of goodwill could not be written off against profits. For sole trader or partnership businesses established before 1 April 2002 (i.e. from when the intangible fixed assets rules were introduced), it is therefore not generally possible to incorporate the business, have the company purchase the goodwill from the former business owner and obtain a deduction for the write-off of expenditure on goodwill in the new company over time. However, there are certain exceptions to this general rule prohibiting the company from claiming a deduction under the intangible fixed assets rules upon acquisition from a related party upon incorporation. These are broadly where:

- the sole trader or partnership acquired the goodwill after 31 March 2002 from an unrelated third party (Sch 29, para 118(2)(b)); or
- the unincorporated business (or any other person) created the asset after 31 March 2002 (Sch 29, para 118(2)(c)).

The second exception above means that a deduction for goodwill is potentially available if a sole trader or partnership commenced trading on or after 1 April 2002, and developed the business goodwill prior to incorporation. This will become an increasingly common situation over time, as more sole traders and partnerships which commenced trading on or after 1 April 2002 grow their businesses and enhance the value of free goodwill. Please contact me if you need any further guidance in this area.

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