

# Rent up frustration

Exactly what is the impact of a rent charge on entrepreneurs' relief?

KEVIN SLEVIN investigates

whether the payment of such consideration, now or in the past, can lead to the loss of relief.

**T**his article focuses on situations where the decision to charge rent may impact on the outcome of a claim to entitlement to entrepreneurs' relief under the soon-to-be TCGA 1992, ss 169H to 169S, currently found in Finance Bill 2008, Sch 3. Unless noted otherwise, all references below are to the new ss 169H to 169S.

The focus of this article is solely upon the capital gains tax issues. In each of the scenarios explored it is likely that there will be VAT and stamp duty land tax implications of the structure, and consideration needs to be given to property law generally. Where the asset in question is settled property, advisers will need to take trust law issues on board too.

What follows comprises commentary from the standpoint of the entrepreneurs' relief provision in respect of some common scenarios.

## John – a sole trader

Entrepreneurs' relief arises to sole traders who make 'qualifying business disposals' within s 169H.

Let us assume that John has been a sole trader for several years trading from Unit B6, a building owned by him. In recent years, John has outsourced the manufacturing side of his business and this has freed up approximately 40% of Unit B6 which he has let on a short lease to a third party.

Say, in January 2009, John decides to retire and sell the business as a going concern. He immediately finds a buyer and the buyer is happy to let the tenant continue in occupation until his lease expires.

On the disposal of the business the following capital gains arise:

### KEY POINTS

- The legislation applies to 'qualifying business disposals'.
- Some worked examples.
- Does letting reduce the relief available?
- Calculating the 'rent restriction'.
- The effect of rent paid before 6 April 2008.
- The application of the legislation to trusts.



Asset	Gain (£)
Goodwill	600,000
Sale of Unit B6	400,000

John has read in the financial pages of his Sunday newspaper that, because the gain amounts to not more than £1 million he will not pay tax of more than 10%. John reports the transaction to his taxation adviser only after the disposal has been made. His adviser starts to consider the issues.

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## Is there a reduction in relief?

The main question which arises is to what extent may John's gain on the disposal of Unit B6 be reduced by entrepreneurs' relief? Is there a restriction because of the letting of 40% of the building for a period of time?

Section 169H(1), (2) and s 169I(1), (2)(a) and (3) combine to require John to demonstrate that he has disposed of a business (or part of a business) which has been owned by him for a period of at least one year ending with the date of disposal. In so doing, John can demonstrate that he has made a qualifying business disposal, being a material disposal of business assets falling within s 169I. These requirements are clearly met. However, John's adviser is also worried about s 169H(3) which contains a further requirement. It reads as follows.

‘But in the case of certain qualifying business disposals, entrepreneurs’ relief is given only in respect of disposals of relevant business assets comprised in the qualifying business disposal: see s 169L.’

Broadly speaking, s 169L has effect so that, where the asset disposed of is used in a trade carried on by a sole tradership or a partnership, it is necessary for the assets comprised in the qualifying business disposal referred to above to be ‘relevant business assets’.

## What is a relevant business asset?

Subject to one important proviso (see below), in the case of a disposal of a sole tradership, a relevant business asset is an asset used for the purpose of a business carried on by the individual (s 169L(3)). There is no requirement in the legislation for the asset to be *fully* used in the business. It must be in use in the business at the time the business is disposed of and, because this was the case in John’s situation, his £400,000 gain on the property disposal is potentially eligible to be reduced by entrepreneurs’ relief.



*It is provided that certain assets are to be considered as ‘excluded assets’ and the gains thereon cannot be reduced by entrepreneurs’ relief.*

Turning to the proviso in s 169L referred to above, it is provided that certain assets are to be considered as ‘excluded assets’ and the gains thereon cannot be reduced by entrepreneurs’ relief. Section 169L(4) reads as follows:

‘The following are excluded assets:

- (a) shares and securities; and
- (b) assets, other than shares or securities, which are held as investments.’

Clearly, John’s interest in the building is neither a share nor a security, but the question is whether the property could be regarded as an investment asset by HMRC. In the author’s opinion, an asset purchased by a trader to provide himself with a place from where to carry on business operated as a sole tradership is not to be regarded as an investment asset, whether or not it is subsequently let as described.

Therefore, John’s claim to entrepreneurs’ relief would not be restricted. If John has made no other disposal attracting relief, he will reduce the aggregate of his capital gains arising on his two relevant business assets by 4/9ths; i.e. from £1 million to £555,555.

## Letting an investment asset

Of course, little in tax is that straightforward. Let’s now say that John had originally acquired the premises

to let it out to third parties. Only subsequently had he installed himself as a part user of the building, occupying say 25% for his sole tradership. Here, entrepreneurs’ relief could well be restricted as HMRC could argue that the asset had remained an investment asset throughout and, as such, then assess the full gain (not just 75% of it) as an ‘excluded asset’ under s 169L(4) (see above). The reality is likely to be that John occupying 60% would be accepted, but if John only occupied 10% he would have to argue his case – with some considerable difficulty. HMRC might perceive his occupation as driven by entrepreneurs’ relief planning!

## Fred and business cessation

The next scenario also involves a sole trader. In March 2009, Fred, who has owned his business for many years, disposes of the goodwill of his business and ceases to carry on his trade. The goodwill disposal crystallises a capital gain of £400,000 which is reduced by 4/9ths to £222,222. Fred owned the premises from where his former business was operated. He has viewed this asset as his ‘pension fund’ and he has let it to the new owner of the business at a full market rent.

After two years, the new owner of the business goes bankrupt and Fred regains vacant possession. Thirty months after ceasing to trade, Fred sells the building to a developer realising a capital gain of £1 million. The question is, can Fred claim the balance of his £1 million lifetime entrepreneurs’ relief?

The answer here is that s 169I((2)(b) and subsection (4) thereof combine to allow the post-cessation disposal of an asset to, nevertheless, be treated as a material disposal of a business asset. This is so even though the asset has been leased to a third party.

Provided the post-cessation asset disposal takes place not more than three years after the business ceases (and the chargeable asset was in use in the business when the

### Example 1

	(£)	(£)
Gain on disposal of building		1,000,000
Maximum gain eligible for entrepreneurs’ relief		
(£1 million less previous goodwill gain £400,000)		600,000
Part of gain not eligible to be reduced by relief		400,000
Part of gain eligible for relief	600,000	
Entrepreneurs’ relief 4/9ths	266,667	
Taxable at 18%		333,333
Therefore gain as reduced by entrepreneurs’ relief is:		733,333
Less: Annual exemption (say)		10,000
Assessable at 18%:		723,333

business was disposed of), entrepreneurs' relief can be claimed. Use during the post cessation of business period (maximum three year period) is not a factor taken into account.

In this scenario, Fred's £1 million gain would be taxed as in **Example 1**.

## Associated disposals

The position regarding an associated disposal, i.e. the disposal of assets owned by an individual and provided either (i) for use in a trade of partnership of which he is a member, or (ii) for use by the owner's 'personal company' in its trade, which is provided for in s 169K, is not so generous.

In the case of such use by a partnership or a personal company (broadly, a company where the asset owner is either an employee or officer thereof and owns at least 5% of the ordinary shares and controls at least 5% of the voting rights by virtue of the shares held) there is a restriction to be made when calculating the availability of entrepreneurs' relief. Put simply, if the asset has been provided in consideration for the payment of rent or other consideration, the relief available is restricted. Where the rent paid is at the level of a full market rent, the relief is reduced to nil. Where the rent paid is less than market rent, the relief is restricted on a 'just and reasonable' basis (s 169P(2)).

Accordingly, if, say, Simon had let a factory to his personal company throughout the period he owned the asset at 50% of the market rent and he makes a capital gain on its disposal (which must, inter alia, be linked to a disposal of his shares in the company in question if it is to be an associated disposal (see s 169K(3)) his entrepreneurs' relief would be restricted as shown in **Example 2**.

The £500,000 balance of Simon's £1 million lifetime limit will be available against the gain arising on the disposal of shares in his personal company with which the property disposal is associated.

## Partners and associated disposals

As regards associated disposals involving an asset previously provided by one or more partners in a partnership, there is a particular point to note.

This concerns the precise wording of the rent restriction operating in associated disposal situations. The restriction is found in s 169P(4)(d) and applies where 'for the whole or any part of the period for which the assets which (or interests in which) are disposed of are in use for the

### Example 2

	(£)	(£)
Say, gain on sale of factory		1,000,000
Less: 50% not eligible for relief		500,000
		<hr/> 500,000
Gain eligible for relief	£500,000	
Less: entrepreneurs' relief (4/9ths)	222,223	
	<hr/>	<hr/>
Balance		277,777
Assessable		<hr/> 777,777

purposes of the business, their availability is dependent on the payment of rent'.

The question which arises is what constitutes 'rent'? What is the position if, say, an asset is owned jointly by two

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partners, A and B, out of a total of six equity partners and under the partnership arrangements there is an agreement that A and B will receive the first tranche of profits, being £50,000, to reflect the level of rent which would be payable for a similar property if the two partners were not making the property available? Does this arrangement constitute the payment of consideration which is to be regarded as rent? At first sight, an unwelcome answer for many partners (possibly putting a smile on the faces of their colleagues) is found in s 169S(5) which defines rent as including 'any form of consideration given for the use of the asset'. From this it would not be unreasonable to say that the profit-sharing arrangements do constitute consideration given for the use of the asset and for the entrepreneurs' relief to be restricted.

However, it is understood that, in most instances HMRC will not take this view, the motive behind the extended

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meaning of rent is to catch other payments dressed up to be something other than rent.

## An iniquitous situation?

As regards associated disposals and the payment of rent, etc. a government minister has indicated (at the Report stage of the Finance Bill) that the Treasury will look again at the iniquitous situation currently found in the provision relating to past rents.

The pre-6 April taper relief provisions do not penalise a taxpayer for letting an asset to his personal company or to a partnership, but those same lettings will restrict entrepreneurs' relief – even if such rents were to cease with effect from 6 April 2008. The legislation requires entrepreneurs' relief to be restricted where at any time during the period of ownership of the asset it was in use in the partnership or the personal company. If the rent were to be waived from 6 April 2008, a restriction in the



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level of entrepreneurs' relief available will still apply as regards the previous rental payments.

We await developments here.

## Trust gains

The next issue concerns the use of trust assets in consideration for the payment of rent by a beneficiary to the trust.

There is a limited form of entrepreneurs' relief available here, but it is important to understand that trusts do not have their own lifetime allowance of entrepreneurs' relief. What is possible – in limited circumstances – is for a beneficiary to effectively surrender part of his £1 million lifetime relief to the trustees.

This is not an article about entrepreneurs' relief and trust gains generally but, briefly, the situations where a trust can benefit from entrepreneurs' relief can be summarised as follows.

- Only 'qualifying beneficiaries' of a trust can surrender relief to the trustees of that trust. Broadly, 'qualifying beneficiaries' are those with an interest in possession rather than discretionary beneficiaries, but see s 169J(3) for full definition.
- The disposal must be either shares in a company which is the qualifying beneficiary's personal company (referred to earlier in this article) or be a 'relevant business asset' – an asset used in a business carried on by the beneficiary in question.

In addition, in the case of an asset disposal by the trustees, it must be shown that:

- throughout a period of at least one year ending on the asset disposal in question the asset was used for the purposes of a business carried on by the qualifying beneficiary (or by a partnership of which he is a member); or
- it was so used throughout a period of one year ending within the three-year period ending on the asset disposal in question; and
- the qualifying beneficiary either ceases to carry on the business in question at the time of the disposal of the asset or has done so not more than three years earlier.

## Rent and excluded assets

Therefore, taking on board the limited circumstances outlined above, the question of relevance to this article is what happens if the trustees charge rent or other consideration for the use of the asset in question? The first point to note is that the charging of rent by the trustees for the use of an asset used by the beneficiary's personal company is not an issue because a trust gain arising on such an asset cannot attract relief; while a trust gain arising on shares in a personal company of a qualifying beneficiary may qualify for entrepreneurs' relief, a trust gain on an asset, say trading premises, let to such a company cannot.

The main issue here is whether or not a trust gain arising on the disposal of an asset, say trading premises, used in a business carried on by a beneficiary can benefit from entrepreneurs' relief where it has been the subject of a rent charge. On the face of the legislation summarised above, the charging of rent is not a factor to be taken into account.

However, there is one more condition not highlighted above. It is arguable that all trust assets, if they are to be eligible for relief, must be 'relevant business assets' as defined in s 169L(2), (3). This being so, the trustees must be able to show that the asset is not an excluded asset within s 169L(4); in particular, not an investment asset. How can such assets held by trustees not be investment assets – irrespective of whether the trustees charge rent?

## Clarification please

In summary, the issue as regards trustees charging a qualifying beneficiary rent is solely one of whether all trust assets are held as investment assets and cannot therefore by their very nature benefit from any entrepreneurs' relief.

If this were to be the case, it would clearly fly in the face of the purpose of the provision and it is to be hoped that after the Finance Act 2008 has received Royal Assent, the position will be clarified. If partners receiving a prior share of partnership profits are not to be treated as receiving disguised rent as described earlier, trustees who hold assets should enjoy similar 'helpful' interpretation of the statute. ■

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