

BUSINESS PROPERTY IN THE CAPITAL TAXES ARENA – A COHESIVE CONCEPT?

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The present Chancellor's stated intention to build a Britain of fairness and enterprise calls for a review of the tax environment in which it is hoped enterprise will flourish. Of considerable interest in this context is the interface between economic policy and the tax favoured status of certain types of business property, together with the increasing alignment of this concept in both the personal and corporate tax arenas.

In this article we focus on the tax advantaged nature of business property for Capital Gains Tax ('CGT') and Inheritance Tax ('IHT') with reference to Business Asset Taper Relief ('BATR'), Business Asset Holdover relief ('Holdover Relief') and Business Property Relief ('BPR').

We further consider certain similarities and disparities of the operations of the various regimes, and the manner in which the definitions of 'business property' show discernible evidence of an increasing move away from a piecemeal approach and toward the development of a more homogeneous test across a number of reliefs.

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BATR

The introduction of taper relief in 1998 effected a substantial alteration of the CGT landscape, and introduced a considerable incentive for investment in unquoted trading companies. Material changes were further introduced in the 2000, 2002 and 2003 Budgets, and for the purposes of this article we focus on the operation of BATR post that date, as this is the most recent indication of current policy trends in the definition of 'business property'.

Outline of the relief

BATR applies to individuals, and operates so that only 25% of a gain, giving an effective tax rate of 10% for a higher rate taxpayer, will be chargeable on disposal of a business asset after a two year holding period. For the purposes of this article the position of individual shareholders is primarily considered, although the relief does of course extend, with some modifications, to trustees and personal representatives.

The definition of what constitutes a business asset for these purposes is essentially threefold:

1. shares, which term includes securities, are business assets if they are shares in a company which is a 'qualifying company' by reference to the individual;
2. the company is a 'qualifying company' if it is a trading company or the holding company of a trading group; and
3. either it is unlisted, or the individual is an officer or employee of the company or of a connected company, or the individual has the power to exercise at least 5% of the voting rights in the company.

Unlisted companies for these purposes includes those with an AIM listing.

It is to be noted that BATR may also apply where less than 10% of the shares or rights in a non-trading company are held by an officer or employee of the company, provided there are no connected parties with additional shares.

Assets other than shares or an interest in shares may also be business assets for the purposes of BATR essentially where they are **used** for trading purposes, which includes by an individual holder as a sole trader or as a member of a

trading partnership, or by a company which comes within the definition of qualifying company by reference to the individual owner of the asset.

This is interesting for this means that commercial landlords holding commercial property as an investment only are eligible for BATR on a disposal of property let to unquoted trading companies and from 5 April 2004 this relief will have been extended to property let to sole traders and partnerships. In this respect the BATR concept of business property is materially wider in some respects than that which applies for BPR.

Distinction between Trading and Investment

A crucial aspect of eligibility for BATR lies in what may be termed the ‘activity test’, namely whether shares are held in a trading company or the holding company of a trading group, or whether an asset is used for trading purposes. From a policy point of view this is uncontroversial and in line with the general approach taken to the capital taxes concept of tax favoured business property, but what is interesting is to observe the parameters of the concept of trading and, thus, ‘business property’ for these purposes, and the increasingly similar definitions across the reliefs, together with the tensions that flow from the remaining differences.

The Revenue’s view on the tests to be applied to determine whether a company is a trading company for these purposes was set out most recently in Tax Bulletin 62. Anything that is a trade, profession or vocation within the meaning of the Income Tax Acts and is conducted on a commercial basis with a view to the realisation of profits comes within the definition of trade.

The definition of ‘trading company’ and ‘group’ for these purposes was altered in April 2002 and applies to disposals on or after 17 April 2002, so that a trading company is, unsurprisingly, a company carrying on trading activities whose activities do not to a substantial extent include activities other than trading activities. For holding companies, instead of looking at the position of the holding company in isolation, as was previously the case, the position is now considered by reference to its 51% subsidiaries and the activities undertaken at subsidiary level, Sch A1 para 6(b) TCGA 1992.

This change was effected to bring the wording of the legislation in line with the actual Revenue approach to the consideration of group holding companies.

Substantial

Of particular relevance in the context of the definition of business assets for BATR is the meaning of 'substantial' for the legislation states that a company or group of companies will be a trading company or trading group if their activities "do not include to a substantial extent activities other than trading activities".

The Revenue considers that substantial in this context means more than 20%, as is stated in Tax Bulletin 62.

The following are the main factors which will be looked to in deciding whether a company or group is trading:

- The amount of income which is generated from investment activity;
- The asset base of the company, having regard to the value of non trading assets, including goodwill, when compared to total assets;
- The extent of resources used for trading and non trading activities.

No one factor is determinative, instead all will be considered in arriving at the decision as to the overall status of activities carried on by a company/group.

These factors, together with the definitions of 'trading company' and 'group' mirror those used for the purposes of Substantial Shareholding Exemption ('SSE') found in Sch 7AC TCGA 1992, particularly in para 20, and could be said to provide an indication of a policy trend in favour of a more consistent approach to the definition of the concept of 'trading' for personal and corporate tax purposes.

In the second 'Corporation Tax Reform' consultation document published in August 2003 the Government invited comments on the perceived benefits of the extension of SSE to investment companies. In view of the largely parallel tests considered for 'trading' purposes in BATR and SSE it has been anticipated that an extension of the ambit of SSE might be reflected in BATR. The Inland Revenue Technical note published as part of the Pre-Budget Report 'Corporation Tax Reform: The Next Steps' was silent on this point but stated the Government 'is still considering many of the issues raised in the responses' (to the Consultation paper published in August 2003). The Budget focussed on corporation tax reform in the areas of management expenses and transfer pricing, but press releases issued as part of the Budget indicated it would continue to look at other areas of the corporation tax system with an eye to reform and publish proposals later in the year. It will be interesting to see if any further

developments occur in the expansion of the ambit of SSE and, potentially BATR, to investment companies.

It is possible to make application to the local Inspector for clearance as to the trading status of a company, both in the context of SSE and BATR, as is set out in Tax Bulletin 62.

Holdover Relief

Holdover Relief operates to allow gains deemed to occur on gifts to be held over when the assets which are the subject of the gift come within the definition of ‘business asset’. Essentially, and very much akin to BATR, such assets are shares in unquoted trading companies and holding companies of trading groups together with some further business asset categories.

It should be noted that when Holdover Relief applies to an asset this will generally result in the ‘loss’ of accrued taper relief with respect to that asset because there will normally be no chargeable gain for the purposes of taper relief on disposal.

The test applied in determining the status of an asset for these purposes is again essentially threefold:

1. there must be a disposal made otherwise than at arms length by an individual and for which a claim for relief under s 165 TCGA 1992 is made;
2. the disposal must be of:
 - (a) an asset or an interest in an asset which has been used for the purposes of a trade, profession or vocation carried on by the transferor, or his personal company, or a member of a trading group of which the holding company is the transferor’s personal company; or
 - (b) shares or securities of a trading company or of the holding company of a trading group, where:
 - (1) the shares or securities are not listed on a recognised stock exchange; or

- (2) the trading company or holding company is the transferor's personal company.

This is supplemented by the anti-avoidance provisions of Sch 7 which provide that if the transferring shareholder has, or within the previous 12 months has been, either:-

- (c) an individual exercising 5% or more of the voting rights; or
- (d) has exercised 25% or more of the company's voting rights

in which case further reference must be made to the precise nature of the assets held by the company in the calculation of the amount of the gift which will benefit from Business Asset Holdover Relief.

Unquoted here again includes companies with an AIM listing.

A personal company with respect to a transferor means a company in which the voting rights were exercisable as to not less than 5% by that individual.

An interesting disparity arises from this in that for BATR purposes an asset held by an individual and used for the purposes of a trade by a partnership of which he was a member would qualify for relief, whereas such assets would not benefit from Holdover Relief.

Unlike BATR where relief on disposals of shares in listed trading companies applies to employees or officers of the company *or* of a shareholder with 5% or more of the voting rights in the company, Holdover Relief only applies to 5% or more shareholders.

Trading

In April 2003 for Holdover Relief the definition of a trading company altered so that instead of making reference to the now repealed retirement relief concepts (in TCGA 1992 Sch 6) of trading activity under which only a 50% trading requirement existed, the BATR definitions apply, so that the more stringent 80% trading activity test must be met if the shares in the company or group are to be eligible for Holdover Relief. Hence this view of 'trading' now applies across BATR, SSE and Holdover Relief, providing evidence of the shift in favour of a unified tax definition of 'trading' and the 'business property' concept.

Restrictions on relief

Where shareholders in companies of the type listed above exceed the permitted control requirements there set out, Holdover Relief is restricted to the extent the group or company holds any ‘non-business’ chargeable assets.

The restriction is calculated by working out the market value at the point of the disposal of all company/group chargeable assets and allowing relief only on the percentage that business chargeable assets comprise of total chargeable assets.

The Revenue make clear in guidance that all assets which, if sold, could give rise to a gain are to be considered as chargeable assets for these purposes even if the assets concerned are currently standing at a loss.

The characterisation of assets as ‘business assets’ in this context means those assets used for trading purposes; essentially relief is denied on investment assets on the balance sheet.

This restriction on Holdover Relief was logical in the context of the 50% trading test based on the ‘wholly and mainly’ concept used in retirement relief. With the extension of the much steeper ‘substantial’ test to the trading threshold which companies must now meet for disposals of shares in them to be eligible for Holdover Relief, the continuing application of these restrictions is questionable. It is notable that such restrictions are not to be found in BATR or SSE, where the stringent ‘substantial’ test is also imposed; therefore where this test is extended to existing capital taxes reliefs, it is difficult to justify the continuing application of restrictions which were devised in the context of the far more relaxed ‘wholly and mainly’ trading requirement.

It is also onerous for those contemplating gifts of business assets to carry out two discrete tests of a company’s activities before they can establish whether unrestricted holdover relief is available on gifts of shares in trading companies.

BPR - IHT

Under the provisions of s 105 Inheritance Tax Act 1984 (‘IHTA 1984’) ‘relevant business property’ is relieved by a quantum of either 50% or 100%, according to its precise nature, where it is subject to a transfer on which IHT would otherwise be chargeable.

The concept of business excludes 'a business carried on otherwise than for gain', and is further proscribed by the definition of 'relevant business property' into which category business property must come in order to qualify for relief.

The test of eligibility for business property is formulated as follows:

1. The nature of activity carried out by the company or partnership which uses the asset or by the company in which the shares are held must not 'wholly or mainly' (on the interpretation or meaning of which term statutory guidance is not given) fall into the category of an 'excluded business' (s105(3) IHTA 1984), specifically these are:
 - a. dealing in securities, stocks and shares
 - b. dealing in land or buildings
 - c. making or holding investments

An exemption is provided for holding companies of subsidiaries whose activities are not 'excluded activities' (s 205(4)(b) IHTA 1984).

2. If the property meets the above requirements but is subject to a binding contract for sale BPR will not be available (s113 IHTA 1984). Options contracts which exist over the business at the time of transfer will not be caught by this.
3. In so far as the property includes 'excepted assets', which are assets which are not and which have not for the previous two years been used for the purposes of the business and which are not required at the time of transfer for future use for those purposes, relief will be restricted in a similar way to as for holdover relief, so that in valuing the relevant business property which may be relieved, the value of any excepted asset is not included (s112 IHTA 1984).
4. Finally, the property must have been held for two years before transfer (s106 IHTA 1984).

Relevant Business Property

Relevant business property falls into two distinct categories, namely that eligible for 100% BPR and that eligible for 50% BPR

The following property is eligible for 100% BPR:

- (a) a business or an interest in a business
- (b) securities of a company which are unquoted and which either by themselves or together with other such securities owned by the transferor and any unquoted shares so owned gave the transferor control of the company immediately before the transfer
- (bb) any unquoted shares in a company

Meanwhile the following are eligible for 50% relief:

- (cc) shares in or securities of a company which are quoted and which (either by themselves or together with other such shares or securities owned by the transferor) gave the transferor control of the company immediately before the transfer
- (d) any land or building, machinery or plant which, immediately before the transfer, was used wholly or mainly for the purposes of a business carried on by a company of which the transferor then had control or by a partnership of which he was then a member
- (e) any land or building, machinery or plant which, immediately before the transfer was used wholly or mainly for the purposes of a business carried on by the transferor and was settled property in which he was then beneficially entitled to an interest in possession.

Unquoted for these purposes means not listed on a recognised stock exchange, and as with BATR and Holdover Relief, an AIM listing is again permissible.

An interesting disparity arises in that an asset held by an individual which is used for the purposes of a trade carried on by a partnership of which he is a member or by a company of which he had control will only be eligible for 50% BPR. If though it is brought into the partnership or transferred to the company a transfer of it will then benefit from 100% BPR. This stands in contrast to the position under BATR.

‘Wholly or Mainly’ Test

Recent authorities on whether the activities of a business come ‘wholly and mainly’ within excluded activities provide interesting illustrations of judicial thinking on this point, and further provide an interesting illustration of increasing

symmetry between judicial and statutory approaches to these concepts in the tax arena.

In *Farmer and another (executors of Farmer, deceased) v Inland Revenue Commissioners* [1999] STC (SCD) 321 the question was considered in the context of a farm and lettings which were conducted as a single business, and on which the Revenue sought to deny BPR by reference to the lettings aspect of the business. The Special Commissioners found against the Revenue, and set out the 5 factors to which they considered regards should be had in considering the applicability of s 105(3) IHTA 1984:

1. The overall context of the business.
2. The values of the capital employed for the respective parts of the business.
3. The time spent by employees on the various parts of the business.
4. The turnover of the investment activities.
5. The profit generated by the investment activities.

No factor was taken to be determinative, but the matter was instead to be looked at 'in the round'.

In *Weston (executor of Weston, deceased) v Inland Revenue Commissioners* [2000] STC 1064 the applicability of the 'wholly or mainly' test was considered in the context of the business of running a caravan park and whether it was eligible for BPR or instead consisted wholly or mainly of the making or holding of investments. Lawrence Collins J proposed a 3 stage test as follows:

1. Identify the investments
2. Identify the purposes for which the investments are being held – namely are they held as investments or are they ancillary to trading purposes
3. Consider the scope of the investments, and conduct a comparison of investment and non investment activity for the purposes of a 50% test, and finally consider whether the ancillary activities take on the character of supporting either trading or holding investments.

In *IRC v George and another (Executors of Stedman deceased)* [2004] STC 147 the company owned a caravan site and performed a number of services for

caravan residents for which it charged a fee. The question arose as to whether the nature of the activities carried on by the business were trading or instead came within the concept of ‘wholly or mainly’ holding investments.

In the Special Commissioners’ hearing the property was held to constitute relevant business property on the basis that the business of the company was the provision of services and not the business of holding investments.

On appeal however Laddie J² reversed the Special Commissioners on the grounds that the three stage test formulated in *Weston* was correct, and that the application of this test led to the conclusion that that: ‘what falls within the “investment business” bag is not only the core holding of the land and the receipt of fees or rent in respect of its use, but also all those activities which, viewed through the eyes of the average businessman would be regarded as ‘incidental’ to the primary activity, namely the making or holding of investments.

The Court of Appeal in a recent judgement have reversed the High Court decision and restored the decision at first instance. The approach adopted in the High Court was stated to be wrong on the basis that one should not consider the matter as “the opening of an investment bag” into which are placed activities considered ancillary to the investment activity, namely the holding of land. Carnwath LJ further states that it is not required to determine the exact terms of the investment activities. This is because the statute does not require such categorical decisions, which in that case was stated to fail to observe the nature of running caravan parks.

This is interesting as it indicates a return to the general approach previously set out, and indicates that the whole nature of the business is to be considered, instead of what appears to have been considered to be an attempt to formally distinguish trading and investment activities.

Overview of the authorities

Other than the impression that Britain is a land soon to be wholly submerged under a sea of caravan parks, a review of these authorities leads to certain interesting conclusions.

² [2003] STC 468

Overall, the distilled essence of the above considered cases indicate many similarities between recent developments in the application of the ‘wholly and mainly’ test for BPR and the statutorily applied ‘trading’ tests for BATR, with a similar approach of considering all factors in the round, looking to the asset base of a company and to the purposes for which those assets are held. Of particular interest is the fact that this has been influenced by an increasingly parallel development between judicial reasoning as to the concept of trading, and the tests for trading activity in the context of BATR, Holdover Relief and SSE which are proscribed by statute and Revenue practice. The recent decision in *George* may be said to continue this in so far as it focuses on no specific facet of the business but again looks at a number of factors, and places much emphasis on the importance of the actual facts, as found by the Special Commissioners, rather than the performance of a complex test, as the touchstone for deciding whether the business is trading.

The distinction deriving from the use of ‘wholly and mainly’ with respect to the former and ‘substantial’ with respect to the latter must however be acknowledged, in so far as the former imposes a 50% requirement and the latter imposes an 80% requirement.

Holding Companies

While exemption from exclusion by reference to the ‘wholly and mainly’ test is effectively granted to holding companies of groups, the shares of which comprise relevant business property, no statutory definition of group exists for these purposes.

In *Grimwood Taylor v IRC* (2000) STC (SCD) 39) a contention that a group could exist where companies were all controlled by the individual was dismissed by the Special Commissioners.

It will be interesting to observe if further authorities emerge on this point, and whether the increasingly parallel development of the case law on the interpretation of the ‘wholly and mainly’ test and the concept of trading for BATR, Holdover Relief and SSE, is followed in this context.

Excepted Assets

The excepted assets hurdle must also be overcome if BPR is to apply without restriction. This will apply where assets which are the subject of an IHT transfer have not been used wholly or mainly for business purposes or are not required

for such use in the next two years. Where this is the case BPR will be restricted to that part of the business which reflects the value of the assets which have been used for business purposes. This has strong resonances with the anti-avoidance rules of Sch 7 TCGA 1992 in the context of Holdover Relief.

Section 112(6) IHTA 1984 makes reference to assets which have been used for personal benefit, this is aimed at assets such as luxury cars or yachts. Where, despite not having been used in the previous two years the assets are required for future use they may not fall within the excepted assets restriction (s 122(2) IHTA 1984).

Barclays v CIR [SC 3107/97] outlines indications as to what constitutes ‘future use’ for these purposes. Cash which is not set aside for a defined project within the short term is unlikely to be considered a business asset required for future use. Working capital however and short term fluctuations are not likely to be excluded, and also assets held to support income in a recession are permitted under this head, and an illustration of the factual situations which will be considered for these purposes was set out at LN 112 of the CTO Manual.

Minority Investment

Investment assets held within a single trading company which is not wholly or mainly involved in investment activities will not be excepted if the investment assets are held for business purposes, for this purpose ‘business’ can include the holding of investments without the s105(3) IHTA 1984 exclusion. The Revenue apparently accepts that this protects assets which are used for ‘minority’ investment business purposes, thus creating an opportunity to hold a modest level of investments without prejudicing relief.

The position is to be contrasted with that for unincorporated business, where it is necessary to effect an apportionment between trading and investment activity for mixed use purposes under s112(4) IHTA 1984.

The excepted assets position is more complicated for groups, and s111 IHTA 1984 excludes the value of subsidiaries which in isolation are wholly or mainly excluded business under s105(3) IHTA 1984 unless the subsidiary is a group holding sub-company, or a group property holding company. On this basis it is better to spread investments between a number of trading subsidiaries rather than isolate them in one mainly investment company.

Contrast with Holdover Relief

The application of the ‘wholly and mainly’ test here is defensible for, despite the clear erosion of its use in capital taxes reliefs, the restrictions imposed on the availability of BPR by the excepted assets requirements effectively places a further hurdle that must be overcome for the relief to apply without restriction.

This is in contrast to previously commented on unfairness of the continuing application of the shareholder control tests in the context of CGT Holdover Relief, given the recent extension of the ‘substantial’ 80% trading test to it.

Two year ownership test

The two year use test with respect to excepted assets must be distinguished from the two year ownership requirement, which simply imposes the obligation that for the property to be relevant business property it must have been owned for two years prior to transfer.

This however makes no requirement that the property have been relevant business property for this time, so that an asset comprised of unquoted shares held in an investment company for two years can qualify for BPR if the company changes activity and becomes a trading company carrying on relevant business activity prior to transfer.

Conclusion

The extended application of the requirement that trading activity be ‘substantial’ if property is to come within a category which is eligible for tax favoured status will be of significance for successful family businesses which often choose to retain profits and frequently diversify risk into investment activity, this can now have a substantial impact on the availability of both CGT and SSE reliefs.

Therefore, where there is no immediate prospect of a disposal on which BATR is not available, it may be possible to hold some investment assets in a trading company/group without prejudicing the availability of BPR provided the 50% threshold of the ‘wholly or mainly’ test is not breached.

There is a closer alignment of the concepts underpinning the definitions of ‘business property’ and ‘trading’ in both the personal and corporate tax arena. This may well herald the beginning of a more marked overlap between what have been perceived as the traditional personal and corporate tax boundaries. Given

the increasing complexity and sophistication of investment strategies undertaken by high net worth individuals this is of particular pertinence to those who frequently advise them, for such strategies frequently require familiarity with an increasing cross spectrum of tax concepts. It will be interesting to see if there is further alignment between corporate and personal tax, particularly in light of the anticipated extension of SSE relief to investment companies with trading subsidiaries when full results of the Corporation Tax Review are published.