Institution **CIOT - CTA**
Course **APS Owner-Managed Businesses**

Event **NA**

Exam Mode **OPEN LAPTOP**

Answer-to-Question-_1_

To: Sonya Style
From: Tamara Scilia
Date: 11 May 2023

Report to discuss the commencement of the new art gallery and related issues

Introduction

Sonya Style (SS) has recently sold the trade and assets of her company AA Construction Ltd (AACL) to an unconnected company, and would now like to start a new business of an art gallery.

This report will discuss the tax implications of the sale of the trade and assets,along with the set up of the new art gallery business hilst giving recommendations on the best way to structure the business.

Disclaimer

This report is for the sole use of SS only. Liability will not be provided for anyone else who may rely on this report.

We have relied on the information provided to us by the client. The tax legislation is correct at the time of writing.

Scope

The report will cover the following areas:

1. Sale of the trade and assets of AACL
2. Purchase of the art gallery
    2.1. Purchase by SS
    2.2. Purchase by a new company
    2.3 Purchase by AACL

3 Appendices

I trust that this report will provide useful information in respect of the requested matters, however please do contact me if you have any further queries.

Glossary

The following abbreviations have been used in this report:
SS - Sonya Style
AACL - AA Construction Ltd
BRL - Bigger Restorations Ltd
CT - Corporation Tax
CA - Capital Allowances
AIA - Annual Investment Allowance
VAT - Value Added Tax
T&A - Trade and assets
GW - Goodwill
TWDV - Tax written down value
IA - Indexation Allowance
TOGC - Transfer of Going Concern
SDLT - Stamp Duty Land Tax
SA - Self Assessment
IT - Income Tax
NIC - National Insurance Contributions
EYLR - Early Year Loss Relief
BADR - Business Asset Disposal Relief
CGT - Capital Gains Tax

Executive Summary

SS should purchase the new art gallery business in the name of AACL.

This will provide limited liability protection for SS.

AACL should seek confirmation from BRL that they have met the conditions for a TOGC to apply.

AACL should carry back the loss arising in the year ended 31 March 2025 to the year ended 31 March 2024, to receive a CT repayment of £26,035.

SS should sell the private collection to AACL at full market value to allow extraction of profits tax-free.

SS should extract a tax-efficient salary of £11,908 and take the rest of the profits as dividends.

AACL should reclaim the VAT on the refurbishment costs, saving £18,000.

Main Report

1. Sale of the trade and assets of AACL

CT

The sale of the T&A's of AACL to BRL will result in an increased taxable profits for AACL in the year ended 31 March 2023.

The sale of the goodwill (GW) will increase the trading profits by £100,000, which is the full sales proceeds,as it had already been fully amortised by AACL and so the TWDV was nil.

The sale of the freehold property will give rise to a chargeable gain by AACL of £120,000 (Appendix 1). IA is available on the purchase cost of the building using the retail prices index from the date of purchase in April 2008 to the date that indexation was abolished in December 2017. This reflects the change in value of the cost over time, reducing the taxable gain.

The sale of the vehicles will give rise to a balancing charge for CA's of £60,000, increasing the taxable profits of AACL. This is because the TWDV of the vehicles is nil, and so tax relief has already been fully provided for the purchase.

The sale of the equipment would not be taxable by AACL, as they are classed as chattels which have both an original purchase cost and sales price of under £6,000 for each individual iten.

The sale of the stock at undervalue would result in a small trading loss of £5,000 (Appendix 2) for AACL. This will reduce the taxable profits for AACL.

Overall, the sale of the T&A's will result in an increase of taxable profits of £275,000 (Appendix 3) for AACL in the year ended 31 March 2023. As total company profits will be greater than £250,000, this will be subject to CT at 25%, which is £68,750.

If AACL purchases the new art gallery business, there may be opportunities to reduce the CT, which is discussed later in this report.

VAT

As AACL is VAT registered, VAT will need to be charged on the sale of certain assets at the standard rate of 20%. VAT will be charged on the sale of the GW, vehicles, equipment and stock, but not the freehold property unless it has been opted to tax.

However, assuming BRL is VAT registered (as its a larger company), the sale may be a Transfer of Going Concern (TOGC). This would mean that VAT does not need to be charged on the sale of the assets.

To be a TOGC, BRL will need to be VAT registered and continuing the same trade as AACL with no significant break in trading following the purchase.

Recommendation

AACL should seek confirmation from BRL that they have met the conditions for a TOGC to apply.

2. Purchase of the art gallery

The purchase of the new art gallery business could be by SS personally as a new sole trade, by AACL as a new trade, or by a new company.

2.1. Purchase by SS

New sole trade

A new sole trade by SS would be taxable on SS personally. Assuming SS is not currently registered for SA as she has only taken a salary of £65,000 from AACL and no other income, SS would need to register for SA by 5 October 2024. Tax Returns will need to be filed annually, with the return and IT payable due 31 January each year. The first tax return will be for the 2023/24 tax year due 31 January 2025.

SS will also need to register for Class 2 and Class 4 NIC's. Class 2 NIC is £3.15 per week from the commencement of the sole trade, although as there is an expected loss in the 2023/24 tax year it would not be payable until the 2024/25 tax year.

Class 4 NIC is payable on profits over £11,908, at a rate of 10.25% up to £50,270 and then 3.25% thereafter. As with Class 2, this would not be payable until the 2024/25 tax year when profits have arisen.

IT is payable on all profits which arise above the Personal Allowance of £12,570, regardless of how much SS actually requires. The rates of IT are 20%/40%/45% depending on income levels.

If the new gallery business is to employ staff, SS will need to register for PAYE and submit monthly returns to HMRC, along with Class 1 Secondary NIC of 15.05%.

The first accounting period for SS would be the start of trade on 1 June 2023 to 5 April 2024. The 31 March yearends which have been used in the forecast profit and loss accounts is the recommended accounting period end date, as it will avoid any profits being taxed twice.

A business in SS' personal name would mean that SS would be fully liabile if anything was to happen to the business.

Calculation of profits

Profits will be calculated on an accruals basis, which means when invoices and receipts are provided. If turnover is less than £150,000, there is an option to use the cash basis instead, which enables profits to be based on when payments are actually received and paid. However, the use of the cash basis restricts the use of losses, so it is not recommended in the first year of accounts. Going forwards the turnover will be greater than the threshold so its recommended to use the accruals basis from the start.

There will be significant expenditure in the first year due to the purchase of the assets from The Creative Touch, and the refurbishment of the gallery.

The freehold property to be purchased will be a capital asset, and therefore no deduction is available from trading profits. The cost of the property will be deducted from any gain which arises on future sale of the property.

However, as an s198 election has been made to allocate £37,300 to the fixtures, this amount will be available for deduction via CA's in the period of purchase.

The purchase of the equipment will also qualify for CA's, along with the fixtures to be purchased in the refurbishment. Qualifying expenditure of up to £200,000 can be claimed at 100% relief using the AIA each year. Therefore, a total of £57,300 (Appendix 4) will be available for full deduction from the year ended 31 March 2023 profits.

The decorating cost of £3,000 will be deductible from trading profits as long as it is not capital in nature, such as decorating newly built rooms.

The marketing cost of £9,000 will be also be fully deductible from trading profits.

The stock of £25,000 purchased will be fully deductible from trading profits when sold.

The other elements of the refurb are capital items, and relief will not be obtained until the building is sold.

<u>Losses</u>
Further to the expenditure, a loss of £104,140 (Appendix 5) will arise in the first year of trade.

The loss can be carried forward to the future profits of the trade, which will occur in the 2024/25 tax year and 2025/26, although this delays the relief.

The loss can be offset against SS' general income for the year 2023/24, and also carried back to the previous tax year 2022/23. The loss relief is restricted to the higher of £50,000 and 25% of general income which is £16,250, so £50,000. Assuming SS will no longer be taking a salary from AACL due to it likely being liquidated, this would not be recommended as it would not be fully utilised and would have some left to carry forward to the next tax year.

Alternatively, as it would be a loss in the first 4 tax years of trade, SS could claim EYLR to offset the loss against general income of the previous three tax years, with the earliest first. This will provide a IT repayment at 20%/40% to SS, obtaining immediate relief.

Recommendation
An EYLR claim should be made on the 2023/24 tax return to obtain an immediate IT repayment.

VAT
The assets being purchased from The Creative Touch will have VAT charged on the purchase price, as they are VAT registered. This means that the assets, apart from the freehold property as its more than 3 years old and not opted to tax, will have VAT of 20% added.

As discussed earlier, if the TOGC conditions are met then VAT will not need to be charged. For this, SS will need to become VAT registered immediately. SS will be carrying on the same trade of an art gallery business, and although a refurbishment is to take place which will delay the start of trade by 3-4 weeks, its unlikely to be classed as a significant break in trading. Therefore as long as SS registers for VAT, no VAT will be charged.

As a result of becoming VAT registered, SS will be able to reclaim any VAT charged on the refurbishment costs, saving £18,000 (£90,000 @ 20%).

Recommendation

SS should register for VAT before the purchase of the art gallery business to qualify for a TOGC, and to recover £18,000 of VAT on the refurb.

Closure of AACL

In order to fund the new business, SS would need to extract profits from AACL.

Given that she will no longer be trading, the accounting period will end for AACL on the date of cessation.

As SS will no longer be trading from AACL, the company should be closed. The reserves will be greater than £50,000 due to the sale of the T&A, so if closed without a formal liquidation, the distributions will be treated as dividends. The first £2,000 will be tax-free, then the rest will be taxed at 8.75%/33.75%/39.35%. This is an expensive way to extract, given that most of it will be taxed at 39.35%.

Alternatively, SS could appoint a liquidator to formally liquidate AACL. Although there will be fees associated with this, the distribution will be treated as capital and subject to CGT rates of 10%/20% above the annual exemption of £12,300.

BADR could be claimed on the capital distribution, which would mean it is all taxed at 10% CGT rather than 20%.

SS' shares in AACL would qualify for BADR, as she holds more than 5% of the share capitla and voting rights, works for the company and AACL is a trading company, and all these conditions have been met for the past two years. This will save CGT of 10% on the gain.

BADR needs to be claimed by the anniversary of the 31 January following the tax year of closure, but should be claimed on the tax return including the closure to obtain immediate relief.

Recommendation

SS should appoint a formal liquidator to close AACL which will obtain capital treatment on the distribution.

SS should claim BADR on the gain of the shares in the 2023/24 tax year by 31 January 2025.

Future use of sole trade

Going forwards given that profits are likely to significantly increase, the soletrade should be incorporated into a new company to avoid paying high rates of income tax. SS can then extract profits tax-efficiently. We can discuss this when the new business starts to make a profit in 2025.

2.2. Purchase by a new company

Purchasing the business through a new company would mean that the business would have limited liability and therefore less risky than a sole trade.

However, any loss which arises in the first year of trading would only be able to be carried forward to the next accounting period, which limits the options available and also delays the tax relief from the initial set up costs.

SS has also expressed she would not like to provide a loan from AACL to another entity, and she has limited funds to input personally so it is likely a significant bank loan would be required, which would be expensive and SS would like to avoid.

Given that AACL would no longer be trading it would need to be closed down, which also provides the costly extraction issues mentioned above.

Recommendation
Due to the limitations on the use of the loss in the first year, and funding issues we do not recommend setting up a new company.

2.3 Purchase by AACL

By purchasing through AACL, the new business will have limited liability, limiting the risk to SS to her share capital.

CT
AACL could purchase the new business. The future profits will be taxed at the main rate of 25%, with marginal relief for any profits between £50,000 and £250,000. The effective rate of the margin is 26.5%.

If AACL was to purchase the new business, the profits will be calculated in the same way as it would for a sole trade as mentioned previously.

Own collection used by AACL
If SS introduces her own private collection of stock into AACL, this would be a sale at market value for SS as they are connected. However, as they are chattels with a cost and market value below £6,000, no CGT will arise for SS. SS could sell the assets to AACL for the full market value, which would increase the directors loan for SS, which she could extract any time tax-free.

Recommendation
SS should sell the private collection to AACL at full market value to allow extraction of profits tax-free.

Losses

If AACL was to purchase the new business, the profits will be calculated in the same way as it would for a sole trade as mentioned previously. A loss of £104,140 (Appendix 5) would arise in the first year.

AACL could offset this loss against any other trading profits arising in the 2023/24 accounts year. However, as the old trade has been sold there is unlikely to be any relief obtained from this.

The losses will be carried forward to be used against future profits. This will save CT in the year ended 31 March 2025 of £25,412 (Appendix 6).

Alternatively, the loss can be carried back to the previous 12 months. Given that the sale of the T&A have arisen a profit of £285,000, carrying back the loss of £104,140 will save CT at 25% which is £26,035.

Recommendation

AACL should carry back the loss arising in the year ended 31 March 2025 to the year ended 31 March 2024, to receive a CT repayment of £26,035.

This is a greater saving than through a sole trade so AACL purchase is recommended.

VAT

AACL is already VAT registered, so no admin would be required on commencement of the new business.

AACL will charge VAT on any sales, and can reclaim the VAT on its purchases, in particular the refurbishment costs mentioned previously.

Recommendation
AACL should reclaim the VAT on the refurbishment costs mentioned above, saving £18,000.

PAYE
By running the new business through AACL, the PAYE scheme will not need to be closed and can be kept open for the new staff. P45's will need to be issued to any old staff leaving.

Extraction of profits
SS has been taking a salary of £65,000 which is expensive as it would have been subject to IT at 20%/40%, along with Class 1 Primary NICs at 13.25%/3.25%, and AACL paying Class 1 Secondary NICs at 15.05%

However, it is recommended that SS takes a tax-efficient salary of £11,908, which will avoid any Class 1P arising for SS with only a small amount arising for AACL. SS will still obtain her state pension entitement too. The rest of profits can then be taken as dividends, which are subject to IT at lower rates of 8.75%/33.75%/39.35%. There is also a tax-free dividend allowance of £2,000.

The salary would be deductible by AACL reducing CT, but dividends are not deductible.

Recommendation
SS should extract a tax-efficient salary of £11,908 and take the rest of the profits as dividends.

Overall recommendation
Running thew new business through AACL will obtain the greatest tax relief, and avoid admin of closing a company and extracting funds, and setting up a new sole trade. AACL is already registered for VAT & PAYE. Given that profits will increase, a

company is recommended so as to extract profits efficiently.

3. Appendices

Appendix 1 - Sale of freehold property

		£	
Sales price		250,000	
Cost		(100,000)	
Gain before indexation		150,000	
IA (See below)		(30,000)	
Gain after indexation		120,000	

Indexation factor = (278.1-214)/214 = 0.300
IA = 0.300 X £100,000 = £30,000

Appendix 2 - Sale of stock

		£	
Sales price		25,000	
Cost		(30,000)	
Trading loss		(5,000)	

Appendix 3 - Total taxable profits of sale of T&A

		£	
GW		100,000	
Freehold property		120,000	
Vehicles		60,000	
Equipment		0	
Stock		(5,000)	
Taxable profit		275,000	

Appendix 4 - Capital Allowances

		AIA	
		£	
S198 election		37,300	
Display cases/sundry equipment		5,000	
Refurbishment fixtures		15,000	
		57,300	

Appendix 5 - Loss for Y/E 31.3.2024

		£	
Loss per forecast		(9,840)	
CA per Appendix 4		(57,300)	
Stock		(25,000)	
Decorating		(3,000)	
Marketing		(9,000)	
Loss for the year		(104,140)	

Appendix 6 - AACL loss utilisation

C/F
£75,000 x 26.5% = 19,875
£29,140 x 19% = 5,537
Total saving = £25,412