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Application and Professional Skills

Taxation of Owner-Managed Businesses

Suggested Solution

TO: COLIN DUST
FROM: TAX ADVISOR
DATE: NOVEMBER 2020
SUBJECT: STRUCTURE OF BUSINESS FOR NEW PRODUCT DEVELOPMENT

INTRODUCTION

The key matters addressed in respect of the proposed new product development are to advise on the tax implications of the two proposed structures and to recommend which is best as well as minimising future liabilities by utilising reliefs and exemptions.

EXECUTIVE SUMMARY

Our key recommendation is to use a new limited company to develop the product:

- This provides the potential for claiming enhanced research and development tax reliefs which could be worth just over £54,000.

- The gain which Dust & Flow Products Ltd ("D&FP") makes on the sale of its shares may be free of tax due to the Substantial Shareholding Exemption.

- It avoids the tax problems associated with the loaning of money by D&FP to a partnership and resulting penalty tax issues for the company.

- The tax liability for you and Gary on profits will be lower if extracted as dividends from a limited company than as partnership profits, primarily due to National Insurance liabilities.

In addition, we would recommend that:

- the company should register for VAT as soon as possible to recover the VAT on any expenses.

- the proposed expenditure and the nature of the research and development should be reviewed to maximise the tax credits referred to above with advance assurance being sought from HMRC.

Any gain on the sale of the business would qualify for entrepreneurs' relief (ER) and the first £10 million of capital gain would attract a rate of 10% for individuals who are shareholders.

Owning shares jointly with your wife may enable utilisation of unused annual exempt amounts (AEA) and basic rate bands and a further £10 million of ER, if she is an employee or director.

You should have a shareholders' agreement which sets out the relationship between all parties, including the obligations of each party and what happens in the event of a disagreement, which your solicitor can advise on.

GENERAL MATTERS

Before looking at the two proposed structures there are a number of key areas to consider.

Forecast figures

It is assumed that the figures contained in the forecasts are accurate. You believe you will incur costs of £300,000 before income is generated. In year three you have a further deficit of £100,000. Even with the funding from D&FP you are risking your personal wealth. Obtaining available tax reliefs to reduce the cost is therefore important.

Whilst you are confident that the project will succeed profitably, we must consider what happens if this is not the case. The product may never get past the development phase or the future sales may not be as good as you hope.

Trading Status

Tax relief for trading losses is only available where the trade has actually commenced. Here it is possible that the trade may not start if the development is unsuccessful. Costs prior to the commencement of trade (broadly when you start to market and sell your product) are classed as "pre-trading expenditure" which are treated as incurred on the first day of the trade.

Your assumption is that trading will begin on the first day of year three which means that the £300,000 of costs incurred in the first two years will only be allowable then.

Analysis of Costs

Costs will need to be reviewed to ensure they are allowable costs and are not, for example, capital.

Revenue costs include sub-contract labour, Gary's pay, employee costs, rent and other overhead costs. The costs of manufacturing the pipe will be revenue in nature but unsold product will be carried forward as stock at each period end although it is assumed for the purposes of this report that there is no stock on hand at the end of each period.

The costs of building the machine will be capital although a claim for capital allowances can be made, which will increase the losses available. Annual investment allowance or research and development first year allowances may be available.

VAT

The business could voluntarily register for VAT to recover the VAT on the costs they incur. VAT incurred on costs prior to the date of registration can be recovered but subject to a period of 4 years for goods still held at the date of registration and only 6 months for services.

PARTNERSHIP WITH GARY AND D&FP

Unlimited liability

A partnership normally has unlimited personal liability which could be problematic during development of the product and once sales commence (for example if any pipes are defective). This risk is reduced by using a Limited Liability Partnership (LLP).

Profits/Losses

A partnership is transparent for tax purposes. You and Gary will be liable to Income Tax and National Insurance Contributions (NICs) on your shares of profits as they arise which could give considerable tax and NICs liabilities for each of you if the development is successful. Profit allocated to D&FP would be liable to Corporation Tax but they are not entitled to any profit share. There are tax avoidance rules for profit shares from partnerships to a connected corporate partner but these do not apply.

Normally annual investment allowance (AIA) at a rate of 100% of cost applies to qualifying capital additions. However, where there is a corporate partner an AIA cannot be claimed. However, it would appear that all of the machinery is being used for the purposes of qualifying research and development so First Year Allowances could be claimed, also at a rate of 100%.

If the trade commences, the expenses incurred before you start trading are allowed as a deduction on the first day of trading. Appendix 1 shows the calculation of the position of the LLP and shows that a loss of £400,000 arises in year 3.

If the trade never actually begins you will receive no tax relief for the costs you have incurred.

If you start trading but make losses as forecast, relief for losses can be obtained in different ways. Each partner can choose how to utilise their losses.

The choices you have are:

- Carry losses forward against future profits of the partnership.
- Offset losses against your income from D&FP in either the year of the loss and/or the previous year. There is a restriction of the higher of £50,000 or 25% of your income. In the year to 5 April 2020, your income level was £50,000 and so there should be no restriction.
- In the first four years of the trade, the losses can be carried back against your other income of the three previous years, with losses set against the earliest year first, subject to the same restriction noted above.

If the business succeeds the losses in the first four years of £400,000 are probably best carried forward against the substantial profit in year five which would otherwise be liable to income tax up to 45%.

If you set the losses against your dividend income from D&FP then you would only obtain tax relief at 7.5%, the tax rate on your dividends. Part of the losses will obtain no relief at all as your personal allowance would be wasted as you cannot restrict the losses to preserve this. This can be reviewed at the time to optimise the relief.

Funding

If you borrow to invest in a trading partnership, tax relief will be available against your income for the interest paid. Tax relief is only available from the time the trade starts and the same restrictions as noted above for losses also applies. The house is owned jointly with Estelle which could create a problem in obtaining a loan in your sole name but you would have to discuss this with the lender. If it was a joint loan HMRC could challenge the deduction of 100% of the interest. If the partnership could not repay the loan, then relief is available on the money lent but only as a capital loss. No relief would be available if the partnership does not commence trading.

The loan from D&FP would be from a company to a partnership in which one of its shareholders is a partner so a tax liability arises (called the 'loans to participators' rules). If the loan is not repaid within nine months of the end of the company's accounting period an amount of 'penalty tax' equal to 32.5% of the loan, £32,500 would need to be paid to HMRC by D&FP. This 'penalty tax' is repayable 9 months after the end of the company's accounting period in which the loan repayment occurs. We assume that D&FP would therefore wish to avoid the loan route.

If the loan is written off in the future, if the business is unsuccessful, there would be a tax charge for you as if the loan written off was a dividend but with a potential Class 1 NICs charge.

There could be a taxable benefit on you relating to provision of an interest free loan but where the monies are being used for a trading project no benefit arises. However, if the trade does not start the condition would not be satisfied so a benefit would be calculated using the official interest rate, currently 2.5% per annum.

Future Sale

If the business is sold the loans will be repaid without tax cost to you and net proceeds will be distributed in line with the capital sharing ratio.

You and Gary, as partners in a trading business may qualify for 'Entrepreneurs' Relief (ER) on gains made with the Capital Gains Tax (CGT) rate being 10%. The key conditions to qualify for ER are that it is:

- a disposal of the whole or part of a business;
- the business has been owned for at least two years ending on the date of the disposal.

You and Gary should therefore qualify for ER. There is a lifetime limit of £10m on gains qualifying for ER with any excess being taxed at the general CGT rate of 20%.

For D&FP the gain on disposal of their partnership interest would be liable to corporation tax at the current rate of 19%. Indirectly, yourself and Estelle would benefit via your shareholding in D&FP and you would need to consider how this is extracted from the company, if at all.

Potential gain on sale

If the sale takes place at £5m, your share would be £3m. Ignoring the annual exempt amount, then the gain would be taxed as follows:

3,000,000 x 10%	£300,000

Your net proceeds would be £2,700,000.

D&FP would receive £1.25m of proceeds and would pay corporation tax of £237,500 on that amount.

COMPANY STRUCTURE

The same issues regarding the commencement of the trade apply as above as do many of the other points but there are significant differences:

- Losses can only be carried forward against future company profits. The losses will be relieved at corporation tax rates, currently 19%. Any profits would also be taxed at this lower rate.
- The loan to participators issue would not arise if the loan from D&FP was direct to this company as it would not be a loan to an individual.
- The company has limited liability and provided the directors do not act negligently commercial claims will be limited to assets of the company.

<u>Research and Development Costs</u>

Companies can qualify for a tax relief for qualifying 'research and development' (R&D) expenditure. This relief gives an additional deduction of 130% of qualifying costs. For every £1,000 of qualifying costs corporation tax relief would be given for a deemed cost of £2,300. Alternatively, it is possible to make a tax repayment claim equal to 14.5% of the 'surrenderable' loss. In the above example a cash repayment could be claimed of £2,300 @ 14.5% = £333.50 instead of the additional tax deduction. This relief is available on pre-trading expenditure even if the trade does not start. The refund has the effect of reducing the overall cost of the project.

A qualifying project is one where there has been an 'advancement in technology'. HMRC offer an advanced assurance scheme where a detailed product analysis can be submitted before the claim is submitted. We would recommend this option was taken.

Only certain categories of expenditure qualify for the additional reliefs. These are:

Employee costs where they are working on the project directly and allowable costs include salaries, employer national insurance and pension contributions. Gary's costs should fall within this category.

Subcontractor costs are limited to 65% of the cost unless connected or an election is made. We will need to review the sub-contractor labour costs to ascertain the allowable element.

Computer software costs are allowed where used in the project.

Consumable items including the costs incurred on the materials for developing the pipe prior to going into commercial production and utilities.

General overhead costs would need to be reviewed to see if any qualify.

Appendix 1 includes a calculation of the impact on the corporation tax position for the company and an estimate of the value of claiming the tax credit. The figures may be higher if any of the overhead costs qualify.

These amounts should be claimed in order to maximise the cash available to develop this product.

<u>Funding</u>

Loans

You will be borrowing personally to loan to the company and the interest paid will be allowable against your income. The restriction will apply to limit the relief to the maximum of £50,000 and 25% of your income. You could consider charging interest on the loan as another method of extracting profits before any dividends. The company would be required to deduct basic rate tax at source but this could be offset against the tax liability on the interest.

The loan from D&FP to the company will not give rise to a tax liability. However, as it will be interest free this may have implications for the shareholders of D&FP as it may affect the trading status of the company. These can cause issues for CGT and Inheritance Tax (IHT) purposes which we can discuss.

<u>Future Sale</u>

If the product is a success you will look to sell the shares. Repayment of loans would have no tax cost.

Any gains that you and Gary make should qualify for ER subject to the conditions being satisfied which for a share disposal are:

- Shares in a trading company
- Shareholding of at least 5% with full voting, income and equity rights which have been held for at least two years
- The shareholder has been an officer or employee for the same two-year period.

These conditions should be satisfied and you will be in a similar position to the partnership option above.

On the disposal of their shares D&FP should qualify for an exemption called the 'substantial shareholding exemption' (SSE). If the relevant conditions are satisfied the gain would be fully exempt from corporation tax. The key condition for this relief is that the company has held at least 10% of the issued share capital for a continuous period of at least 12 months.

As above, by virtue of the shares you and Estelle hold in D&FP you will indirectly benefit. You will similarly need to consider how these funds are to be used in that company.

In summary, your capital gains position would be the same as for a partnership interest but the gain arising in D&FP would be exempt by utilising SSE.

Potential Loss

Again, we must consider the implications of the product not succeeding so that loans you and D&FP have made to the company are irrecoverable.

Your loss would again crystallise as a capital loss. For D&FP on the loan may be allowable for corporation tax purposes as the companies are not connected for loan relationship purposes.

Income extraction

If the company is profitable, those profits are liable to corporation tax at only 19%. You note you will extract profits by way of dividend which are not liable to NICs, giving a significant saving. Based on your other income any dividends would be taxable at 32.5% unless the income exceeds £150,000 when the dividend rate increases to 38.1%.

Gary has a salary of £75,000 but as far as we are aware no other income. The first £2,000 of his dividends would be taxed at 0% with the balance taxed at 32.5% or 38.1% as indicated above. We do not know if Gary is married or in a civil partnership to consider tax mitigation.

Conclusion

It would appear that it would be more beneficial to use a company for this project for the following reasons:

- Potential for claiming R&D reliefs, giving a cash tax credit if claimed to provide additional financing;
- The gain on the sale of the company is likely to be tax-free for D&FP;
- The loan from D&FP to an LLP could create tax liabilities both when made and if it is written off; and
- The tax liability on profits if the trade is successful will be greater if this is an LLP.

We would strongly recommend that a shareholders' agreement is prepared to clearly define the rights of all the shareholders.

BRINGING ESTELLE INTO THE BUSINESS

Although recommending using a company, we will consider the tax implications of bringing Estelle into either type of business.

Estelle's total income has totalled £34,000 in recent year so she does have some available basic rate band so any income allocated to her would potentially suffer tax at a lower rate than income allocated to your so there would be an overall tax saving for your combined income. This would apply if this was a partnership or a limited company.

If you did use a partnership, Estelle would be able to have a share of the losses and as she has property income, it may be of greater benefit to utilise losses against her other income. However, loss relief is restricted in early years of trading if you are a non-active partner which would necessitate her spending at least 10 hours per week working on the business.

Sale of the businesses

The lifetime limit on ER is £10m. If Estelle owned part of the business she would have £10m relief available to her.

If Estelle were a partner in the partnership, then she would qualify for the relief regardless of her involvement in the business if it had been trading for the qualifying period.

If the business was operated via a company, then she would need to be an employee or director of the company as well as owning at least 5% of shares.

Recommendation

It would be recommended that Estelle has a stake in the business as it will allow income to be split if generated and utilisation of her AEA and ER when the business is sold.

Appendix 1: Comparison of tax position for company and LLP options

Assumptions made in calculations:

All stock produced in the year is sold, all expenses allowable, trade begins start of year 3

1. **LLP**

The allowable pre-trading expenses will be as follows:

	£
Materials	30,000
Subcontract costs	80,000
Employee costs	93,000
Rent	24,000
Overheads	23,000
Total	250,000

Pre-trading capital costs eligible for capital allowances £50,000

	Year 3	Year 4	Year 5
Sales	40,000	110,000	610,000
Total in year costs	120,000	110,000	210,000
Pre-trading costs	250,000		
FYA Capital allowance	70,000		
Profit/(loss)	(400,000)	Nil	400,000

2. **Company**

R&D enhanced costs: it is unclear if the overheads are qualifying so they are not included

	Year 1	Year 2	Year 3	Year 4	Year 5
Materials for pipes	20,000	10,000	Nil	Nil	Nil
Subcontract labour (allow 65%)	26,000	26,000	19,500	6,500	3,250
Gary's costs	20,000	21,000	21,000	22000	25,000
Total	66,000	57,000	40,500	28,500	28,250
Enhanced 130%	85,800	74,100	52,650	37,050	36,725
Total R&D relief	151,800	131,100	93,150	65,550	64,975

Pretrading

The R&D tax credit can be claimed for losses generated through pre-trading costs.

	Year 1	Year 2
Total R&D relief	151,800	131,100
Tax credit @14.5%	22,011	19,009

If the tax credits are claimed, the losses relating to those costs are not carried forward as pre-trading costs to deduct in year 3. However, the remaining costs are still available so the pre-trading expenses are £250,000 less £123,000 (claimed above) = £127,000

This affects the corporation tax position as follows:

	Year 3	Year 4	Year 5
Sales	40,000	110,000	610,000
Costs (as for LLP)	120,000	110,000	210,000
Pre-trading costs	127,000		
Enhanced 130% for R&D costs	52,650	37,050	36,725
FYA	70,000		
Profit/(loss)	(329,650)	(37,050)	363,275
Surrenderable loss	93,150	37,050	
Potential tax credit	13,507	5,372	

The loss relief available to the company in year 5 will depend on whether R&D tax credit claims have been made but would be a minimum of £236,500, leaving taxable profits of £126,775 which would give a corporation tax liability of £24,087.

Assuming the maximum R&D tax credit claims had been made for years 1 to 4 the potential cash refunds would be nearly £60,000 although there would be a liability in year 5 of just over £24,000. Alternatively the R&D enhancements in years 1 to 5 totalling £286,325 could simply obtain corporation tax relief at 19% of £54,401.