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

Event **NA**

Exam Mode **OPEN LAPTOP + NETWORK**

Answer-to-Question-_1_

Report for Adam Alfaro

To: Adam Alfaro

From: Paul Carter

Title: Structure of Sale of Charlotte Ceramics Ltd

Date: 2 May 2024

Introduction

This report is for you (Adam Alfaro) to follow up on our meeting on 1 May 2024 in which the sale of Charlotte Ceramics Ltd (CC or company) was discussed. The report will cover the tax implications of the possible ways of structuring the sale of CC to to Superior Ceramics Ltd.

Please note, this report is intended for your use only and we cannot accept any liability for the use of this report by any other person. The report is based on the tax legislation as of today's date and also relies on the information that you have provided to us being accurate and correct, including the valuation of the company's assets.

I will be more than happy to discuss these matters with you further once you have had a chance to digest this report.

Executive Summary

- Two main options are available to dispose of CC, being a

disposal of trade and assets or a disposal of your shares in the company.

- A sale of the assets in CC would result in capital gains, balancing charges, and additional taxable trade profits arising in its final accounting period. This would result in a CT liability of £110,375 for CC for the YE 30 June 2024 (Appendix 6).

- If the sale of assets is chose as the method of disposal, the sale of the factory and warehouse to the purchaser will require a s.198 election to confirm the value of the fixtures and fittings being transferred to the purchaser. If possible, it would be advised to minimise the value of these assets to minimise the balancing charge that would arise on the cessation of trade of the company.

- Once the company has disposed of its assets, approximately £1m of funds will be available to extract from the company (Appendix 7). The extraction of the funds would result in a doule layer of taxation arising due to the CT liability mentioned above arising from the sale of assets, and either an income tax or capital gains tax liability arising on the extraction of funds.

- If a sale of assets does occur, it is advised that this is structured via a formal winding up of the company so that the extraction is treated as a capital disposal of your shares in the company. This would result in a CGT liability for yourself of £107,373 (Appendix 8) and leave you with net cash proceeds of £895,290.

- If an asset sale is used, in order to reduce this tax

liability, the company could make a pension contribution in order to reduce the corporation tax liability in the company and also reduce the level of profits that need to be extracted.

- The company would need to deregister for VAT purposes if a sale of trade and assets is used.

- Business asset disposal relief can be claimed on £350,000 on any sale arising from the capital distribution of funds or the sale of your shares in the company.

- A sale of company shares will avoid the double layer of taxation. This would result in an estimated CGT liability for yourself of £129,448 (Appendix 9), but would leave you with larger net cash of £983,590. Therefore, it is advised that a sale of shares is used in order to reduce the overall level of tax paid by yourself and the company. However, consideration of whether the purchaser would pay as much for the shares must be taken.

Sale of Trade and Assets

The sale of the individual assets is the optimal choice for the purchaser, so this option will be considered first. The various tax implications of this option are considered below.

Sale of Chargeable Assets

The sale of the assets owned by the company will result in

chargeable gains, which will be taxed inside of the company to corporation tax.

Goodwill

The sale of the goodwill at its market value of £200,000 that was acquired by the company in 1998 will result in a chargeable gain of £190,000 (Appendix 1), as this is an intangible asset that was purchased prior to April 2002. The amortisation of the goodwill has no impact on this.

Sale of Office and Warehouse

The sale of the office and warehouse at their market value of £250,000 will not result in a capital gain or a capital loss. Although there is a gross gain of £55,000 when taking into account the expected sales proceeds less the original cost of the property and the cost of the extension, companies can also claim the indexation allowance which essentially is an additional deduction from the sales proceeds to account for inflation. As shown in Appendix 2, the indexation would result in a capital loss if the indexation was dedcuted. However, indexation cannot create or increase a capital loss, so the disposal of this asset would result in a capital gain of nil and no tax liability would arise on this asset sale.

Sale of Factory

The sale of the new factory would result in a capital gain of £91,200 as shown in Appendix 3. A similar calculation is carried out, with the cost of the land and the costs of construction

being deducted from the expected sales proceeds. Due to the cost of the land, no stamp duty would have been payable on the purchase op the land so no deduction is available for stamp duty, although the purchaser will have a stamp duty liability on the acquisition of the factory.

The construction expenditure of £225,000 does not include any relevant VAT. VAT would have been chargeable on the construction work due to the fact that it was the construction of a commercial building. However, given that you would have used the factory in the trade and CC is VAT registered, it would have been able to recover the input VAT. Therefore, the VAT exclusive amount has been included in the calculation.

Additionally, as the factory was constructed after 29 October 2018, structeres and buildings allowances (SBAs) would have been claimable on the costs of construction (but not on the cost of the land itself). This would exclude the fixtures qualifying for capital allowances. It has been assumed that SBAs were claimed at a 3% writing down allowance from 30 June 2021. The impact of this on the sale of the factory is that the SBAs claimed must be added to the disposal proceeds when calculating the capital gain, and this is shown in Appendix 3.

The capital gain will be included in the total taxable profits for the company.

Capital Losses

As shown in Appendix 5, the total capital gains arising in the company on the sale of the assets would be £281,200. However, the

company has capital losses of £25,000 brought forward which can be offset against the gross capital gains.

Additionally, as the value of the shareholding in Crowley Glass Ltd is virtually nil, the company can claim to crystallise a capital loss on a notional disposal of these shares for nil proceeds. This would result in a capital loss of £50,000 which can also be utilised against the capital gains arising on the asset sales.

Sale of Stock

The sale of the stock at market value will result in additional trade profits of £34,000 for the YE 30 June 2024. This has been included in the taxable profits in Appendix 6.

Balancing Charges

The sale of the assets will result in balancing charges arising in the company as a result of the sales proceeds of the plant and machinery and fixtures and fittings exceeding the tax written down value of the capital allowances pools. This is shown in Appendix 4 and will result in a balancing charge of £151,500, which will be included in the trade profits for the YE 30 June 2024.

No capital allowances are available in the period of cessation, so no writing down allowances or annual investment allowance can be claimed on the new equipment purchased in the period for £5,000. However, it will still need to be included in the main pool.

The sales proceeds for the fixtures included in the warehouse, the vehicles, and the equipment will all be deducted from the main pool, whilst the integral features within the warehouse and factory will be dedcuted from the special rate pool.

No capital gains will arise on these disposals, as no assets will be sold for more than they are worth.

It is worth noting here that the disposal values used for the fixtures and fittings of the warehouse and factory have assumed to be market value. However, a joint election will be required between yourself and the purchaser to confirm the value of the fixtures disposed of to confirm that the sales value matches their acquisition value for capital allowances purposes. A smaller sales value would be advised if possible to minimise the balancing charge arising, although the purchaser would need to agree to this and this would reduce the capital allowances that they can claim.

Corporation Tax Liability for YE 30 June 2024

Assuming that the standard trade profits arising in the company for this period is £50,000, there would be a corporation tax (CT) liability for CC of £110,375 as shown in Appendix 6. Because of the sale of the assets in the company, total taxable profits arising would exceed £250,000 and therefore the company would pay CT at the main rate of 25%.

The CT liability would be due by 1 April 2025.

This is the negative side of an trade and asset sale in comparison to a sale of shares as discussed below, as there is a tax liability arising in the company and also on yourself when the profits are extracted.

Extraction of Profits

Once the sale of the assets is completed, you will subsequently need to extract the cash proceeds from the company, and this can be achieved in various ways.

Firstly, you would need to collect the cash from all debtors and also pay all remaining creditors outstanding. This would leave net cash proceeds to extract of £1,002,663.

Additionally, Charlotte Retail Ltd will need to be wound up if you also plan to wind up CC. This can be achieved using a simple striking off procedure given that the company has not traded and only has £1,000 of cash in the company. The £1,000 of cash can be paid as a dividend to CC, and as distributable reserves are less than £25,000 this would be classed as a sale of the shares in the company by CC. No tax liability would arise as the proceeds would equal the cost.

Salary/Bonus or Dividends

The first option of extracting the cash from the company would be to pay yourself an additional salary or bonus. However, given the large amount of cash to be extracted, this would result in an extremely large ioncome tax laibility at a marginal rate of 45%, and class 1 primary and secondary NICs would also be payable on

the amount paid. The amounts would be deductible for the company, but this would not be tax efficient and it is not recommended to distribute the cash in this way, if an asset sale is used.

Alternatively, a dividend could be paid which would mean that no NICs would be payable on the amount extracted. However, you would again have an extremely large income tax liability at a marginal rate of 39.35%, which would also not be tax deductible so the CT liability would remain the same. This option is therefore not advised.

Potential to Make Pension Contribution

Another alternative would be for the company to make a tax free contribution into your pension. Assuming this can be argued as being wholly and exclusively for the purpose of the trade, the pension contribution would be tax deductible in the company and no income tax and NICs would be payable.

This would reduce the level of profit liable to CT in the period of cessation, and would also mean that there is less cash to distribute on a potential winding up (as discussed below).

A maximum pension contribution of £60,000 can be made each year into your pension without an annual allowance charge arising. Additionally, you can also use any unused annual allowance from the three prior tax years, provided you were a member of a pension scheme in those years.

I do not have any additional information on your pension schemes or any pension input in previous years, but this is definitely

worth considering in order to reduce the CT liability of the period of cessation and to reduce the level of profits that are to be extrcated from the company on a winding up.

As you are older than 55 you would be able to withdraw from your pension, and 25% of this would be tax free. The remaining amounts withdrawn would be liable to income tax at your marginal rate.

Winding up the Company

Alternatively, you could choose to wind up the company using a professional liquidator. Any distributions made during a winding up of the company would be classed as a capital disposal of your shares in the company, resulting in a capital gains tax (CGT) liability on yourself. If this was to take place on 30 June 2024, a the CGT payable would be due by 31 January 2026. This would result in a CGT liability at either 10% or 20%, which would make the distribution more tax efficient.

The liquidator would be appointed and would be responsible for paying all of the company's debts and collecting all amounts owed to the company, as well as then distributing any remaining assets to yourself. This would add an additional cost of around £10,000 to the process of distributing the cash, but the cost savings would likely outweigh this cost.

A striking off of the company would be cheaper, but this is not available given that the amount of cash to distrubute exceeds £25,000.

Base Cost of Shares and CGT Liability

When calculating the capital gain on the capital distribution of the cash, the base cost of your shares is deducted from the proceeds, which in this case would be the cash of around £1m (after taking into account liquidator fees).

The base cost of your shares in CC is made up of two lots of shares.

The first group of shares are the shares that you acquired from your wife in April 2002. As you acquired these from your spouse, they would have transferred to you at your wife's original cost of the shares in what is known as a no gain no loss transfer, which would be £9,800.

The second group of shares would be the shares that you acquired from your wife on her death, and the base cost of these shares are the probate value at the date of her death, being £275,000.

Therefore, your total base cost of the shares is £284,800.

As shown in Appendix 8, this would result in a capital gain of £711,863 on yourself, which I have assumed will take place in the 24/25 tax year as above. Your annual allowance of £6,000 can also be deducted in arriving at this figure.

<u>Business Asset Disposal Relief</u>

The standard CGT rate that would be applied to your gain would be 20% given that you are already a higher rate taxpayer because of your level of salary and dividends extracted from the company.

However, you would also be able to claim partial business asset disposal relief on the capital gain arising because:

- You have owned the shares for at least two years.
- You have been a director of the company for at least two years.
- The company has been a trading company for at least two years.

However, because the company has ceased trading, you must ensure that the profits are distributed within three years of ceasing to trade, otherwise BADR would not be available.

The investments that the company own would not impact on its trading status, as these would be worth less than 20% of the asset base and turnover of the company.

BADR would mean that the gain is charged to CGT at rate of 10% instead of 20%. However, there is a lifetime limit of £1m for BADR, and as you have already used £650,000 of your allowance, you would only be able to claim BADR on £350,000 of the resulting gain, as shown in Appendix 8.

Ultimately, this would result in a CGT liability of £107,373.

<u>VAT</u>

The sale of the trade and assets to the purchasing company would likely be classed as a transfer of a going concern (TOGC), assuming that the trade continues to be carried on in the new company. This would mean that no VAT would need to be charged on the sale of the assets transferred.

Assuming that no option to tax the factor or warehouse has been made, these would all be VAT exempt supplies as they are commercial freehold buildings that are both more than three years old. This would mean that the TOGC would also apply to the buildings.

On ceasing to trade, the company must deregister from being a taxable entity for VAT using a VAT7 form and this must take place within 30 days of ceasing to trade.

Additionally, any output VAT on business assets still held on deregistering must be paid over to HMRC, unless the output VAT on such assets is less than £1,000.

Other Issues

It is worth noting that an asset sale is usually more complicated and time consuming than a sale of shares as discussed below. This may cause a delay in you being able to receive the sales proceeds on the sale.

However, it would mean that there is less chance of warranties or indemnities being claimed against you as the purchaser would not be acquiring the history and liabilities of your company.

Conclusion on Sale of Assets

The main issue with the sale of assets is that there will be a double layer of taxation arising. The company would have a substantial CT liability at 25% of the profits arising from the

sale of the shares, and then you would also have a tax laibility on extracting the resulting cash from the company.

It may therefore be a better option to look at selling the shares to the company as discussed below.

However, if the sale of assets does happen, then it is advised to extract the cash by way of a winding up of the company so that the income is treated as a capital disposal of your shares at a reduced rate of tax. Additionally, we could look at making a contribution to your pension in order to minimise the level of CT liability arising and the amount of cash that needs to be extracted.

Sale of Shares

An alternative option of disposing of the business would be a sale of shares to the purchasing company. This would mean that there is no double layer of taxation on the disposal of the business as this would simply result in a single capital gain on the sale of the shares on yourself, with no tax liability arising in the company as the assets would not need to be disposed of.

CGT Liability on Sale of Shares

Although we have no valuation of the shares themselves, I have used the value of all of the assets and liabilities of the company (as shown in Appendix 7) but without the additional CT liability that would arise on the sale of the company's assets. This would mean that approximately £1,113,038 would be received

for the sale of the shares. However, the purchaser may not be willing to pay this much given that their preferred option is to purchase the trade and assets only and do not wish to take on the history and liability of the company.

Your base cost that is deducted from the sales proceeds would remain the same as discussed above, being £284,800, and you would also receive your annual exempt amount (AEA) of £6,000 too. Ultimately, a chargeable gain of £822,238 would arise.

BADR would again be available on the same basis as discussed, with only £350,000 qualifying. This would mean that a higher gain is chargeable at a CGT rate of 20% in comparison to the sale of trade and assets.

As shown in Appendix 9, this would result in a CGT liability of £129,448, leaving you with net cash proceeds of £983,590. This is in comparison to you having net proceeds of £895,290. However, as mention above, this would depend on you being able to receive the estimated value of the shares, which may not be possible under the circumstances.

The CGT liability would be due by 31 January 2026 again if the disposal occurs in the 24/25 tax year, and BADR would need to be claimed by 31 January 2027.

Avoid Double Taxation

This option would clearly avoid the double taxation that would arise with a sale of assets and trade, given that no CT liability would arise from the sale of the assets in the company, and you

would not be required to extract the cash from the company. The company would continue trading as normal with no cessation occurring.

This would therefore result in a more tax efficient method of selling the business.

Stamp Duty

The purchaser would have a stamp duty liability on the purchase of the shares at a rate of 0.5% of the consideration paid for the shares.

VAT

No VAT would be chargeable on the sale of the shares as the sale of ahares is an exempt supply.

As the company would continue trading, there would be no requirement to deregister for VAT.

Other Factors to Consider

As the purchasing company would be acquiring not only the busines but also its history and liabilities, you will be required to provide warranties that there are no undisclosed liabilities and also indemnities should any unexpected liabilities arise. This would lead to a risk that you have to cover any additional costs arising out of any unexpected claims or liabilities arising in CC after it has been sold to the purchaser.

Additionally, you would need to ensure that Charlotte Retail Ltd is wound up before the sale and that Crowley Glass Ltd is also wound up, as the purchaser has made it clear that they do not wish to acquire any investments in the company.

However, the sale of shares would be a lot more straightforward than a sale of assets and you should be able to recieve the proceeds from sale a lot quicker.

Conclusion on a Sale of Shares

The sale of shares would result in a higher CGT liability (on the assumption that more proceeds will be received in comparison to a sale of assets). However, this would result in more cash resulting in your hands due to this option avoiding the double layer of taxation that would arise with a sale of trade and assets.

However, you must take into account the fact that the purchaser may not be willing to pay as much for the shares as they would for the sale of the assets, due to them taking on a company with history.

If, however, a similar level of proceeds can be agreed on for a sale of shares, then we would advise that the sale of the company occurs through a sale of shares rather than a sale of assets, to avoid the double layer of taxtion and more cash resulting in your hands. The sale of shares would also be a quicker and less complicated process.

Appendix 1 - Capital Gain on Sale of Goodwill

	£	£	
Sales Proceeds	MV	200,000	
Less: cost		(10,000)	
Capital Gain		190,000	

Appendix 2 - Capital Gain on Sale of Office and Warehouse

	£	£	
Sales Proceeds	MV	250,000	
Less: original cost		(160,000)	
Less: Enhancement expenditure		(35,000)	
Less: indexation for original cost	(278.1-166.6)/ 166.6 x 160,000 = 0.669 x 160,000	(107,040)	
Less: indexation for enhancement	(278.1 - 217.9)/217.9 x 35,000 = 0.276 x 35,000	(9,660)	
Capital Gain		nil*	
*indexation cannot create a loss			

Appendix 3 - Capital Gain on Sale of New Factory

	£	£	
Sales Proceeds	MV	400,000	
Less: cost	100,000 + 225,000	(325,000)	
Add: SBAs claimed by company	3% x (225,000 – 45,000) x 3 years	16,200	
Capital Gain		91,200	

Appendix 4 - Balancing charges for P&M and fixtures

	Main Pool	**SRP**	
	£	**£**	
TWDV b/f	18,500	nil	
Additions: equipment	5,000		
Disposals:			
Original fixtures in warehouse	(10,000)	(5,000)	
Fixtures in new factory		(35,000)	
Vehicles	(75,000)		
Equipment	(50,000)		
	(111,500)	(40,000)	

Balancing charge	**111,500**	**40,000**	**151,500**

Appendix 5 - Capital Gains for YE 30 June 2024

		Capital Gain/Loss	
	£	£	
Goodwill	Appendix 1	190,000	
Office and Warehouse	Appendix 2	nil	
Factory	Appendix 3	91,200	
		281,200	
Crystallise loss in Crowley Glass Ltd Shares		(50,000)	
Less: capital losses b/f		(25,000)	
Capital Gains		**206,000**	

Appendix 6 - CT Computation for Charlotte Ceramics Limited YE 30 June 2024

		£	
Trade Profit		50,000	
Sale of Stock		34,000	
Balancing charge	Appendix 4	151,500	
Total Trade Profit		235,500	
Capital Gains	Appendix 5	206,000	
TTP		**441,500**	
CT Liability	**441,500 x 25%**	**110,375**	

Appendix 7 - Funds Available to Distribute

		£	
Proceeds from asset sale		1,009,000	
Debtors		75,905	
Cash at bank		63,975	
Trade Profit for YE 30 June 2024		50,000	
Less: CT Liability for YE 30 June 2024	Appendix 6	(110,375)	
Less: creditors		(85,842)	
Net Funds Available		**1,002,663**	

Appendix 8 - Capital Gain on Capital Distribution of Funds

		£	
Sales Proceeds		1,002,663	
Less: Base Cost	9,800 + 275,000	(284,800)	
Less: AEA		(6,000)	
Charegable Capital Gain		**711,863**	
CGT @ 10%	350,000 x 10%	35,000	
CGT @ 20%	(711,863 - 350,000) x 20%	72,373	
Total CGT Liability		**107,373**	

Appendix 9 - Capital Gain on Sale of Shares in CC

	£	**£**	

Sales Proceeds	1,002,663 - 110,375	1,113,038	
Less: cost		(284,800)	
Less: AEA		(6,000)	
Chargeable Capital Gain		**822,238**	
CGT @ 10%	**350,000 x 10%**	**35,000**	
CGT @ 20%	**(822,238 - 350,000) x 20%**	**94,448**	
Total CGT Liability		**129,448**	