# Application and Professional Skills

# Taxation of Owner-Managed Businesses

## November 2024

## Suggested answer

**Report to the directors of Briggs Ltd on the most tax efficient structure for the exit of Pedro Hellas and Dianna Peach and the increased shareholding of Henry Fall.**

## Introduction

The objective of this report is to address the issues raised in the shareholders' meeting of 19 October 2024.

Specifically, this will include:

a) The disposal of all shares held by Pedro Hellas.
b) Employment tax issues on Pedro's proposed termination package
c) The possible sale of shares held by Dianna Peach.
d) A tax efficient increase in Henry's shareholding to 10% of the total share capital.

This report is based on the information provided by yourselves and held in our files and reflects legislation in force on today's date. If there is a delay in implementing our recommendations, a significant fiscal event (such as a Budget), or a change in circumstances, confirmation should be sought as to whether this affects the conclusions and recommendations in this report.

This report is prepared under instruction from the directors of Briggs Ltd. No other party may rely on the advice and recommendations given. Individual shareholders should consider obtaining independent advice before taking any action.

## Executive Summary

We make the following recommendations:

1) All of Pedro's shares should be bought back by the company. Advance clearance should be sought from HMRC to confirm that this disposal will be treated as a capital gain.
2) Pedro should remain a director or employee of the company until the share buy-back is complete. This will ensure that his tax liabilities on the share buy-back are minimised.
3) Small tranches of shares should be bought back by the company from Dianna on an annual basis. The buy-back should be structured such that the taxable element will fall within her basic rate tax band.
4) Henry should subscribe for new shares sufficient to increase his shareholding to 10%. These shares will be forfeitable in the event the company does not achieve specified turnover targets. Both Henry and the company should enter into joint elections under section 431 ITEPA 2003.

## Possible acquisition of Pedro Hellas shares

You have agreed an open market value of £275 per share for Pedro's holding. We have not undertaken any independent valuation of the company but you have confirmed that this represents an arm's length price. This would indicate a total value of £550,000 for Pedro's shares.

On the basis that the shares are not to be sold to a third party then they must be acquired either by an existing shareholder or bought back by the company.

### Purchase by Michael

As shown in Appendix I, a sale of Pedro's entire shareholding to Michael will mean that Pedro will have a chargeable gain (after the annual exempt amount) of £344,000. Providing all of the

conditions noted below are satisfied Business Asset Disposal Relief (BADR) should be available. This will mean that the capital gain will be taxed at 10% resulting in a liability of £34,400. This tax will be payable on or before 31 January in the year following the year of disposal.

For BADR to apply Pedro needs to meet all of the following conditions throughout the two years prior to sale:

a) He must be an employee or director of the company.
b) He must hold at least 5% of
    i) The issued share capital
    ii) Rights in a winding up

The shareholding test is easily met but it is important that Pedro remains a director or employee of the company up to the date of sale of his shares. If he ceases to be an employee or director prior to the sale then he will not qualify for BADR and the tax rate will increase to 20%.

If Michael were to extract the funds to buy the shares from the company by way of salary or dividend then this would attract a very substantial tax charge, therefore this route is not advisable. Instead, he could borrow the funds either from a third-party lender, such as a bank, or from Briggs Ltd. If he borrows from a bank then any interest paid, up to a maximum of £50,000 or 25% of total income, would be a tax deductible expense. He would be able to claim full tax relief for the interest paid through his self-assessment tax return. The reason is that the borrowings are for an "allowable purpose", being the acquisition of shares in an unquoted trading company.

If Michael borrows the funds from the company, then there are both personal and company tax issues to consider, which are explained below.

*Personal tax*

Usually where funds are borrowed by a shareholder from their company then there is an annual personal taxable benefit charge. This is calculated by applying HMRC's official rate of interest to the outstanding loan and deducting any interest actually paid. Fortunately, where the funds are borrowed for an allowable purpose, such as in this case for the acquisition of Pedro's shares, then this tax charge will not apply.

*Company tax*

The company will incur what is known as a "section 455 charge". To the extent the loan is outstanding more than 9 months after the end of the accounting period in which the loan is made then the company must deposit a sum equal to 33.75% of the outstanding loan with HMRC. This is held by HMRC and is only repaid as the loan itself is repaid. In fact the refund from HMRC will be made nine months after the end of the accounting period in which a repayment of the loan is made. If Michael were to borrow the full £550,000 in the accounting period to 30 June 2025 then this would potentially attract a section 455 charge of £185,625 payable by 1 April 2026.

Although there would be no personal tax liability arising from the loan there is a substantial cash-flow impact for the company. Michael will also have a large personal debt to the company that will need to be repaid at some point in the future. In addition Michael will have a stamp duty liability of 0.5% of the purchase price to pay personally.

In view of the above issues a preferred option may be to undertake a company purchase of its own shares.

*Purchase of own shares by Briggs Ltd*

Typically, if a company purchases its own shares from an individual shareholder this will be treated as a distribution and taxed as a dividend. The level of the dividend is the consideration received in excess of the original subscription price of the shares. The original subscription price of Pedro's shares was £1 per share. As such, the potential taxable dividend would be £548,000 (2,000 x (£275 - £1)). This would result in a substantial income tax liability, much of it taxed at 39.35%.

In addition there would be a chargeable gain or loss to calculate. The deemed disposal proceeds is the original subscription value of the shares i.e. £1 per share. The capital gains tax base cost of Pedro's shares is £100 per share being the market value of his shares at the date of acquisition. As such there would be a capital loss calculated as follows:

| | | £ |
|---|---|---|
| Proceeds | 2,000 x £1 | 2,000 |
| Base cost | 2,000 x £100 | (200,000) |
| Capital loss | | (198,000) |

This loss can be offset against any other capital gains realised by Pedro in current or future tax years.

A share buy-back taxed as a dividend is therefore very unlikely to be an attractive option for Pedro.

Fortunately, in certain circumstances a share buy-back made by an unquoted trading company will be treated as a capital disposal (and therefore subject to the lower capital gains tax rates). This will apply automatically where all of the following conditions are met:

a) The shares have been held for a minimum of five years
b) The shareholder is UK resident
c) The buy-back results in a substantial reduction of the shares held (see below)
d) The individual is no longer "connected" to the company after the buy-back (see below)
e) The buy-back must be shown to be undertaken for the benefit of the company's trade

A "substantial reduction" requires the seller to hold no more than 75% of their original shareholding percentage after the buy-back.

Pedro would be treated as still "connected" to the company if he held more than 30% of the issued share capital or loan capital of the company after the buy-back. In practice HMRC usually only allow an individual to retain a nominal (less than 5%) shareholding after the buy-back. If more shares are retained then there is a risk that HMRC would challenge the argument that the buy-back was undertaken for the benefit of the company's trade.

If capital treatment can be achieved then Pedro is treated as realising a chargeable gain on the whole consideration and the tax liability will be the same as that outlined in Appendix 1.

On the assumption that all of Pedro's shares are bought back at the same time for cash then conditions "a" to "d" would be met. Condition "e" is more subjective. The fact that the company's

profitability has been adversely affected by the board disagreements means that it is likely that this condition would also be satisfied.

It is possible to obtain advance clearance from HMRC that a proposed buy back will be treated as a capital distribution rather than a dividend. We would recommend that such clearance is sought.

Based on the cash reserves shown in the 30 June 2024 accounts there are sufficient funds to allow the company to buy-back Pedro's shares in one go.

The company will have a stamp duty charge of 0.5% of the value of shares bought back regardless of whether this is treated as income or capital.

**Termination payment to Pedro Hella**

You have proposed an ex-gratia termination payment of £120,000 payable to Pedro on his leaving employment with the company. As this is non-contractual then it is possible that at least part of the payment can be made tax free. The maximum tax free amount is £30,000. This will usually include any statutory redundancy entitlement. The payment can be broken down as follows:

| | | Tax free | Taxable |
|---|---|---|---|
| | £ | £ | £ |
| Termination payment | 120,000 | | |
| Statutory redundancy | (24,234) | 24,234 | |
| Balance of ex-gratia payment | 95,766 | 5,766 | 90,000 |
| TOTALS | | 30,000 | 90,000 |

The £30,000 is free of tax and NIC. The balance will be taxable and the company will have an employer's class 1A NIC liability but there is no employee NIC liability. If the payment is made before his employment ceases then a normal PAYE code should be applied. If the payment is made after the issue of a form P45 then an "0T" code should be applied.

You have indicated that Pedro has a notice period of 6 months but you would prefer that he leave as soon as possible. In the event Pedro does not work his full notice period then any payment in lieu of notice will be fully taxable and subject to PAYE in the normal way.

**Possible acquisition of Dianna Peach shares**

You have indicated that the objective is to help support Dianna's living expenses as tax efficiently as possible. You do not wish to increase dividends paid by the company and you would like to reduce Dianna's minority shareholding in the company.

It would be possible for the company to buy-back some or all of her shares. A buy-back would be subject to the same conditions as outlined above. However, as there is no disagreement between Dianna and the board it is possible that a buy-back would not meet the "benefit to the trade" condition and as such capital treatment may not apply.

In fact, it is not certain that capital treatment would be beneficial in Dianna's case. It may therefore be advisable to deliberately fail to meet one or more of the capital treatment conditions outlined above for the following reasons:

Firstly, she would not qualify for BADR as she is not an employee or director of the company. As such, even if capital treatment could be achieved her tax rate on gains above her annual allowance would be predominantly at 20%. Any gain falling within her unused basic rate tax band would be taxed at 10%.

Secondly, Dianna's inheritance tax (IHT) position should be considered particularly in light of her ill health. At the moment the value of her shares benefits from business property relief (BPR). This gives a 100% IHT exemption for shares held in an unquoted trading company such as Briggs Ltd. In the event of her death this value would pass to her beneficiaries free of IHT. The proposed buy-back of Pedro's shares will substantially reduce the cash balance in the company and remove any potential argument by HMRC that part of the value of the company consisted of "excluded assets" which would restrict the amount of BPR available. If all of Dianna's shares were bought back then this would convert what is currently an exempt asset into a cash balance potentially subject to IHT at 40%.

Furthermore, the company's cash reserves are not sufficient to buy back all of both Pedro and Dianna's shares at the same time.

On the basis that capital treatment is not beneficial for Dianna then an alternative would be a gradual staged buy-back of Dianna's shares. Such a buy-back would certainly not meet "c" or "d" of the capital treatment conditions. Each buy-back would not represent a substantial reduction and she would remain connected with the company. As a result any buy-back in excess of her subscription price (£1 per share) would be taxed as a dividend.

This would be potentially tax efficient for Dianna for the following reasons.

Dividends are treated as the top slice of an individual's income. Each individual has a £1,000 dividend allowance which is tax free. Thereafter dividends falling within the basic rate tax band are taxed at 8.75%. Where dividends fall into the higher rate threshold, then tax is charged at 33.75%. It would therefore be highly tax efficient if sufficient shares were bought back to utilise her unused basic rate tax band on an annual basis.

Appendix 2 illustrates the tax arising on an annual buy-back of 112 shares. This significantly increases Dianna's net income at a minimal tax cost. In addition, in the event of her death her estate would continue to enjoy full IHT exemption on the value of any shares she still held.

**<u>Increasing Henry Fall's shareholding to 7.5%</u>**

At present Henry holds 2.91% (300/10,300) of the company's share capital. If Pedro's shares are bought back by the company this has the effect of increasing the percentage shareholding of the remaining shareholders. This is because the bought back shares are cancelled. If all of Pedro's shares are bought back then Henry's shareholding would increase to 3.61% (300/8,300).

The directors have indicated that they would like Henry to have a holding of 10%. The gradual buy-back of Dianna's shares will further increase this percentage holding but the impact is likely to be marginal. It is therefore likely that he will need to acquire a further 5-6%.

You have indicated that you would wish any shares to be contingent on the company achieving growth targets.

**Share options**

You could grant share options to Henry. The exercise price would be the par value of the shares but their exercise would be contingent on the company achieving specified growth targets.

Unfortunately, he would not qualify under any of the HMRC approved share option schemes for the following reasons. Enterprise Management Incentive is precluded as he does not satisfy the full time employee test. In addition he could not participate in an executive share option scheme as this would require the exercise price of any shares to be not less than the current open market value.

An unapproved share option could be put in place. Henry would be granted options to acquire a specified number of shares contingent on the company achieving the growth targets. This has the attraction of relative simplicity. In addition, there would be no up-front cost to Henry.

Unfortunately, the tax treatment is not attractive. If the options are exercised in the future then Henry will have an income tax charge based on the difference between the market value of the shares at the date of exercise and the amount he pays for the shares.

The company will be able to claim a corporation tax deduction for the same figure that is subject to income tax on Henry.

**Forfeitable shares**

Instead of granting options you could allow Henry to subscribe for additional shares now. Normally where shares are issued to an employee at less than open market value then there is an immediate taxable benefit on the difference between the market value of the shares and the amount paid for them. Shares could be issued at par value to Henry now that are forfeitable if the turnover targets are not met. As the risk of forfeiture is less than five years then there is no automatic tax charge on acquiring the shares. But as soon as the risk of forfeiture is lifted then there would be an income tax charge on the difference between the market value at that time and the amount paid for the shares. Similar to the tax treatment of the unapproved share option noted above.

An irrevocable joint election can be made by the company and Henry (known as a "section 431 election") within 14 days of the issue of the shares. The effect of the election is to crystallise an income tax charge on the difference between the unrestricted market value at issue and the amount paid for the shares. As to what constitutes market value in this circumstance it should be possible to negotiate a reasonable discount on the £275 per share agreed with Pedro. The reason is that we are considering a very small minority shareholding. Although the section 431 election will result in an immediate tax liability it does mean that any subsequent gain will be subject to capital gains tax in Henry's hands. Providing the required conditions are satisfied BADR should be available such that the gain will be taxed at just 10% on the first £1,000,000.

On the assumption that Henry believes that the turnover targets are achievable and that the company will show future capital growth then the most efficient option would be to subscribe for forfeitable shares and make the appropriate section 431 election. This will crystallise an immediate tax charge but only based on the current market value of a small minority shareholding. Any future growth will most likely be taxed at just 10% on any future sale.

On balance, we believe that the issue of forfeitable shares subject to the achievement of growth targets would be the best option. There is a potential "dry" tax cost for Henry in the event the company fails to reach the growth targets, but the benefits on a successful outcome are substantial.

**APPENDIX 1**

**Capital gain on sale of Pedro's shares**

| | Notes | £ |
|---|---|---|
| Proceeds 2,000 x £275 | | 550,000 |
| Base cost | 1 | (200,000) |
| Gross gain | | 350,000 |
| Annual exempt amount | | (6,000) |
| Taxable gain | | 344,000 |
| Tax due 10% | 2 | 34,400 |

Notes:

1) Despite having paid only £60 per share in 2006 the market value at the time was £100 per share. The difference of £40 per share should have been subject to income tax at the time of issue. The base cost of his shares is the sum of the amount paid and that subject to income tax i.e. £100 per share.
2) Assumes the gain qualifies for BADR.

**APPENDIX 2**

**Buy-back of Dianna Peach's shares**

This assumes identical income and allowances in 2024-25 as 2023-24 and a buy-back of 112 shares at a price of £275 per share. This share price may need to be reduced to reflect the small number of shares being acquired.

| | £ | £ |
|---|---|---|
| Received 112 shares at £275 p/s | | 30,800 |
| Subscription cost 112 at £1 | 112 | |
| Balance of dividend allowance | 700 | |
| Taxed at 8.75% | 29,988 | (2,624) |
| Post tax receipt | | 28,176 |