The Chartered Institute of Taxation

Application and Professional Skills

Taxation of Owner-Managed Businesses

November 2023

Suggested solution

SUGGESTED SOLUTION

From: Pearl Farook

To: Tim Peach on behalf of WA Ltd

Date: November 2023

Report to Tim Peach: On the most tax efficient structure for the investment with Kieran Peach and Natasha Field (Project Shield).

Introduction

The objective of this report is to address the issues raised in your email of 31 October 2023.

Specifically, we will consider what actions can be taken to:

a) Ensure that you structure the project in a way to maximise any tax reliefs for WA Ltd and the individual shareholders.
b) Allow equity participation for Kieran and Natasha.
c) Allow for a tax efficient disposal in 3-4 years.

This report is based on the information in your email 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 Tim Peach on behalf of WA Ltd. No other party may rely on the advice and recommendations given.

Executive Summary

In light of the key objectives outlined above we have considered three operating structures to undertake Project Shield. These are as a division of WA Ltd, as a subsidiary company or as a stand-alone company.

Operating as a division of WA Ltd or as a subsidiary company has the attraction of maximising the opportunity to offset the substantial initial expenditure and any enhanced research and development costs against the other profits of WA Ltd.

Unfortunately these structures would not readily allow either you or Kieran and Natasha to realise the value of your interests in a tax efficient manner. Furthermore, in the case of a division it would be difficult to avoid a dilution of your existing holding.

As such our recommendation is that Project Shield be undertaken by a newly formed company owned directly by you, Kieran and Natasha. This will allow all of the shareholders to dispose of their shares in a tax efficient manner. This is particularly relevant in the case of Kieran and Natasha as they plan to become non-UK resident in the short to medium term.

The key disadvantage of a directly owned company is that the set up and initial research costs will be ring-fenced within the company and will not be available to offset against the profits of WA Ltd. If the project is not successful then it is unlikely that WA Ltd will receive any benefit for the money it has spent.

Possible operating structure

There are a number of ways in which you could structure this project, being:

1) As a division of WA Ltd.
2) As a subsidiary company of WA Ltd.
3) As a separate company owned directly by individual shareholders.

I have set out below the principal advantages and disadvantages of these structures in the context of your stated objectives.

As a division of WA Ltd

In this case Project Shield simply operates as a division within WA Ltd.

Advantages:

This has the advantage of simplicity. You will not incur the costs or compliance burden of forming an entirely new company.

It is likely that a substantial part of the initial expenditure will benefit from the additional tax relief available for qualifying research and development expenditure (`R&D relief`) for small and medium sized companies. I appreciate that you are familiar with this relief as we have made claims on behalf of WA Ltd in the past. I have provided more specific details in appendix 1. As the project will be undertaken within WA Ltd then the costs incurred in the project, together with any enhanced relief will be immediately tax deductible against the total profits of the company.

Based on anticipated revenue expenditure of £400,000 then the total deduction from profits would be up to £920,000.

In addition you have indicated potential capital expenditure of £250,000 on the construction of a new laboratory to undertake the R&D. The majority of this should qualify for 100% capital allowances giving immediate relief against the company's profits.

WA Ltd has a substantial tax liability on the gain arising on the Southampton property. By undertaking Project Shield as a division of WA Ltd then it should be relatively straightforward to defer all of that gain through a roll over relief claim (see appendix 2).

Disadvantages:

Any commercial risks associated with the project will not be ring-fenced financially or legally under this structure. Failure of the project could impact on the whole of WA Ltd.

The intention for Kieran and Natasha to hold shares personally would make this structure problematic, as set out below:

Firstly, if they receive ordinary shares in WA Ltd then this would result in a dilution of your existing holding.

Secondly the shares of WA Ltd have a substantial current value. If Kieran and Natasha are allowed to acquire shares in the company at less than open market value then they will incur a personal income tax charge on the difference between what they pay for their shares and their actual value. The shares would be what are known as employment related securities (ERS). The tax implications are explained in appendix 3.

One way to address the above issues would be to allow Kieran and Natasha and possibly yourself to subscribe for a newly created class of shares (i.e. “A” shares). The Articles of the company would need to be amended such that the benefit of the A shares would be limited entirely to the value of Project Shield. This would have the benefit of limiting their participation to just Project Shield. In addition, it should be possible to argue that the initial value of the A shares is relatively modest. This would allow them to acquire the desired shareholding holding for a modest personal investment.

The difficulty would be the added complexity of ring-fencing the activity of Project Shield and attributing value on a fair basis both initially and in the future.

A more significant disadvantage is that it would be extremely difficult for Kieran and Natasha to realise the value of their investment on a future sale unless the shares of WA Ltd are sold as a whole. It is very unlikely that a third party would wish to acquire their small minority holding. As such any realisation would first require a sale of the trade and assets of Project Shield by WA Ltd. This would crystallise a taxable profit within the company. This profit would be subject to corporation tax at the prevailing rate (potentially 25%).

In order to get Kieran and Natasha’s share of value into their hands and allow them to exit the business, a company buy-back of their shares may be required. To the extent sums are received in excess of the original subscription price then this would almost certainly be taxed as a dividend in their hands and would attract a substantial personal income tax liability. There are limited circumstances where a buy-back of shares could be treated as a capital gain but this is unlikely in the timescale we are considering (One of the basic qualifications for capital treatment is the requirement to have held the shares for at least five years). As such a double layer of taxation would most likely arise under this structure, firstly in the company and then on extraction.

Form a new company (Newco) as a subsidiary of WA Ltd

In this case Newco is formed as a subsidiary of WA Ltd. You, Kieran and Natasha would subscribe for shares in Newco at the outset.

Advantages:

A separate Newco will ring-fence any potential trading risk outside of the main WA Ltd business.

The initial development expenditure may generate tax losses in Newco. These are likely to be enhanced by R&D relief. If Newco is a 75% subsidiary of WA Ltd then these losses can be surrendered to WA Ltd through group relief and offset against the profits of WA Ltd as they arise. If Newco is not a 75% subsidiary, group relief will not be possible and the losses will only be able to be carried forward to offset against future profits (if any) arising in Newco. As such the level of minority shareholding in Newco may be significant. If Kieran and Natasha are to hold the desired 25% then any shareholding by you personally would preclude any group relief.

The initial value of Newco will be low and hence yourself, Kieran and Natasha will be able to subscribe for shares at a relatively low up-front cost.

A future sale of Newco will allow the individual shareholders to dispose of their shares and realise value directly. Provided Kieran and Natasha hold at least 5% of the share capital of the company and are employed by Newco in the two years prior to sale then it is likely they would benefit from Business Asset Disposal Relief (BADR). As such the first £1m of gains would be taxed at 10% rather than the usual 20%.

You fully utilised your lifetime BADR entitlement on your 2016 gain. As such your gain would be taxed at 20% (subject to any available basic rate band).

Any gain realised by WA Ltd on its shareholding in Newco would most likely benefit from the Substantial Shareholding Exemption (SSE). On the assumption that Newco remains a trading company up to the point of sale then SSE will exempt any gain or loss. This exemption simply requires WA Ltd to have held at least 10% of the share capital of Newco for a minimum of twelve months prior to sale.

Disadvantages:

It would be important to demonstrate that transactions between WA Ltd and Newco were undertaken on an arm's length basis. This is to avoid any challenge by HMRC under the post transaction benefits provisions (see Appendix 3). Such a challenge could result in substantial income tax charges for Kieran and Natasha.

Newco will incur substantial expenditure in the initial stages. If this is funded by way of loans from WA Ltd then, in light of the above requirement to transact on an arm's length basis you will need to charge market rate interest on any loans. Where interest is charged and paid then this will be a tax deductible expense in Newco and will be taxable income in WA Ltd.

In the event Project Shield is not successful then some or all of the funding provided by WA Ltd to Newco in the form of loan capital may be written off. As both companies will be under common control then WA Ltd will receive no tax relief for this write off.

Similarly, the SSE provisions would mean that any capital loss arising on the sale of Newco would be exempt.

Any sale proceeds attributable to WA Ltd will be locked into that company. Extraction of these funds would potentially attract a substantial personal income tax charge.

As Newco will be a subsidiary of WA Ltd this could impact on the tax payment dates for WA Ltd. At the moment WA Ltd pays tax on its profits nine months after the end of the accounting period. This is the case for any stand-alone company with profits below £1.5m. This £1.5m limit is divided by the number of companies under common control. As such the formation of Newco would reduce the limit for WA Ltd to just £750k. Where this limit is breached then the tax payment profile changes significantly. The company will be required to make four quarterly interim payments on account. The first six months into the accounting period and then at three month intervals.

Separate independent company

In this case Newco is formed and the shares are held directly by yourself, Kieran and Natasha.

Advantages:

The initial value of Newco would be low and hence the cost of subscription for your shares would be at relatively low.

There will be no dilution of your interest in WA Ltd.

The principal benefit is flexibility in the event of a sale of Newco. The sale of shares would accrue directly to the individual shareholders. Kieran and Natasha would potentially benefit from BADR. As noted below, dependent on their residence status it may be possible to realise their gains free of UK tax.

Disadvantages:

There will be no possibility of group relieving early year losses and the utilisation of any losses will be reliant on the subsequent profitability of Newco.

As you will control both WA Ltd and Newco through your majority shareholdings, if Newco is not successful, then any funding provided by WA Ltd in the form of loan capital will be lost without any tax relief.

Again the two companies will be required to operate on an arm's length basis in order to avoid a personal income tax charge on Kieran and Natasha. In this context WA Ltd would need to charge rent to Newco for the use of the new research facility. This may prevent or limit both the possibility of claiming 100% capital allowance on the construction expenditure and the capacity for this to qualify as replacement expenditure for roll over relief purposes.

On the basis that it is likely that you will control Newco then it will impact on the tax payment profile of WA Ltd as detailed above under the subsidiary company scenario.

Potential future non residence

I believe that both Kieran and Natasha plan to move to Australia in 3-4 years. This may affect their capital gains tax position.

Whilst they remain tax resident in the UK, they will be fully taxable on any capital gains arising here. In the event they cease to be resident in the UK then, provided they meet certain qualifying criteria, then gains on the sale of their shares after they have become non-resident, may fall out of charge to UK tax. They may however be subject to tax in Australia, and appropriate advice should be sought.

Provided they do not return to the UK and resume residence here within five years of leaving then any capital gains on shares realised whilst they are non-resident will be exempt from UK tax. If they do subsequently become resident in the UK in that five-year period then any gains that they have realised will fall back into charge in their tax year of return.

This obviously offers an opportunity to achieve a tax-free capital gain in the event of a disposal of their shareholdings. Evidently it will be essential that they obtain appropriate tax advice in the country in which they may be resident at the time of any disposal.

APPENDIX 1

Research and Development R&D Relief

Qualifying R&D expenditure attracts a number of valuable tax benefits. R&D is an activity with the aim of achieving an advance in science or technology. This may be obtaining entirely new knowledge or researching or evaluating new materials, processes, devices or products.

Revenue expenditure

Revenue expenditure incurred on qualifying R&D will benefit from enhanced tax relief equivalent to 130% of the expenditure. This is in addition to the standard 100% deduction. Qualifying expenditure is that related specifically to the R&D activity and is limited mainly to staff costs, software or consumables together with some subcontracted expenditure. The expenditure must be incurred directly in the R&D project. For example where an employee's time is split between qualifying and non-qualifying activity then their salary costs will be apportioned accordingly.

Where the company is incurring tax losses then the immediate benefit of the enhanced relief is limited. As such it is open to the company to elect to surrender some or all of the relief in return for a tax repayment equivalent to 14.5% of the surrendered loss. This refund may be further restricted where the company does not hold the intellectual property rights of the R&D.

Capital expenditure

Capital expenditure incurred in relation to qualifying R&D can benefit from 100% capital allowances in the year of expenditure. In addition to plant and equipment this includes capital expenditure on buildings and facilities (but not the land value) used specifically for R&D.

APPENDIX 2

Roll Over

The capital gain on the sale of the Southampton property on 11 November 2022 will result in a tax liability of approximately £47,000. The company may elect to defer the tax charge by rolling over all or part of that gain. This would require either the company or a 75% subsidiary to incur qualifying expenditure on assets used in its trade. The expenditure must be incurred within a period of one year prior to and three years after the original capital gain. The effect of such a claim is to defer the tax that would otherwise be payable by reducing the tax base cost of the replacement asset. As such the gain will ultimately crystallise on the sale of the replacement asset.

Qualifying replacement expenditure would include the acquisition or construction of the new production and research facility.

Full roll over relief is only possible where all of the proceeds on the disposal of the original asset is used to acquire qualifying replacement assets. Where there is a shortfall then there is a pound for pound restriction on the amount of the gain deferred. The net proceeds on the sale of the Southampton property was £1,086,000. Based on estimated build costs then full roll over relief will be possible if both the production and research facility qualify.

APPENDIX 3

Employment Related Securities (ERS)

Where an individual who is an employee or director of a company acquires shares in that company then it is highly likely that those shares will be treated as ERS. The only exception to this treatment is if you can demonstrate that the opportunity to acquire the shares arises purely from a close family relationship. Evidently Natasha could not satisfy this exemption. Despite the fact that Kieran is your nephew it is unlikely that this exemption would apply to him. HMRC would most likely argue that Kieran's participation is a result of his work and expertise rather than his family relationship.

If ERS are acquired at less than full open market value then this will attract an immediate income tax charge on the employee. For example, if you allowed Kieran to subscribe for 2,000 shares in WA Ltd at £5 per share but the actual market value of the shares was £40 per share then there would be an immediate income tax charge on the benefit of £70,000 (2,000 x £35 per share).

On the assumption that there is no mechanism to immediately sell these shares then this benefit would be disclosed on the individual's self assessment tax return. Any tax would be payable 31 January following the end of the tax year of issue of the shares.

If there was a mechanism to realise this benefit in cash (for example an imminent sale of the company) or the shares are issued in a company that is controlled by another company, then the shares would be treated as readily convertible assets (RCA). In this case the benefit would be subject to an immediate PAYE and NIC liability in the month of receipt. In such a case it is important that the individual employee "make good" any PAYE and primary NIC liability within 90 days of the acquisition of the shares. Failure to do so would crystallise a further benefit in kind charge based on the PAYE and NIC due.

The issue of ERS will result in a tax deductible charge for the employing company equivalent to the benefit arising to the employee plus any employee's NIC payable

In the event the ERS shares were subject to restriction that impact on their initial value then a further income tax charge could arise in the future. For example, if we continue the illustration of 2,000 shares issued to Kieran above. We have established that the actual market value (AMV) is £40 per share. In the event the shares are subject to some form of restriction then this will reduce the market value to say £18 per share (the restricted market value (RMV)). In the absence of any action by Kieran than his acquisition of such shares for £5 per share would crystallise a benefit of £26,000 (2,000 x £13). Furthermore, on the lifting of the restrictions or sale of the shares then a proportion of any resultant gain would be subject to income tax and not CGT. In the majority of cases the percentage of the gain subject to capital gains tax is the ratio of RMV to AMV. The balance of the gain would be subject to income tax.

In order to avoid the risk of such a charge then the employee can make an election under s.431 ITEPA 2003 (a "431 election"). The effect of this election is to ignore the impact on the restrictions when the shares are acquired. In our example this would mean that Kieran would pay income tax on an initial benefit based on the difference between the amount paid and AMV. By accepting this up-front charge there would be no further income tax charge on sale.

A further potential income tax exposure arises in the event ERS receive post transaction benefits. These arise where the value of shares is artificially enhanced by the actions of a connected party. For example where two companies fail to operate on an open market arm's length basis. This would be particularly relevant in the context of transactions between WA Ltd and any entity undertaking Project Shield.