The Chartered Tax Adviser Examination

May 2020

Application and Professional Skills

Taxation of Owner-Managed Businesses

SUGGESTED SOLUTION

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Proposed Disposal of Shareholding in A & B Footwear Ltd and Setting up New Business

Introduction

As agreed during our meeting on 24 April 2020 the first part of this report considers ways in which your shareholding in A & B Footwear Ltd (`ABL`) could be realised (assuming a value of £150,000). The second part of this report considers setting up a new graphic design business including how this might be structured.

Executive Summary

Share Disposal

The simplest way of disposing of your shares would be a sale to another person.

A capital gains tax (`CGT`) liability of £11800 would arise giving sufficient after-tax sales proceeds to purchase the assets required to set up your proposed business.

To minimise any commercial risk of non-payment receiving the sales proceeds in instalments is not recommended.

If Bob will not purchase your shares directly, in order to avoid dilution of his shareholding he is likely to agree to the company repurchasing them. If this occurred before you have held your shares for 5 years the proceeds would be taxed as a dividend with up to 38.1% tax applying. A repurchase should therefore be delayed until 10 July 2020 when it will be subject to CGT at only 10%.

New Business

The capital expenditure will result in an annual investment allowance claim giving a trading loss for the 2020/21 tax year.

Cash basis accounting is not recommended as this will restrict how this trading loss can be relieved.

It is recommended that early years' loss relief is claimed to generate tax relief at up to 32.5%.

The availability of this trading loss will not alter the recommendation that the buy-back occurs on or after 10 July 2020.

To allow recovery of value added tax (`VAT`) incurred on the initial capital expenditure purchased it is recommended that you register for VAT.

Part I

Realisation of Shareholding
The two main ways to realise your investment in ABL are either a direct sale to another person or by ABL purchasing its own shares.

Direct Sale
A review of ABL`s Articles reveals that the shares must first be offered to Bob, although to the extent he does not want (or is unable) to purchase them a sale to an outside investor is then permitted.

A sale of your shares for £150,000 would result in a chargeable gain of £118,000 (£150,000 - £20,000 - £12,000 (annual exempt amount)). If this occurs on 31 July 2020 this gain will need reporting on your 2020/21 tax return. As you will be eligible to claim entrepreneurs' relief (`ER`) the related CGT liability will be £11,800 (£118,000 x 10% (rather than 20% without ER)) and would be payable by 31 January 2022.

ER will apply because ABL is a trading company (see further below) and for at least two years prior to the share disposal you will have both (i) owned at least 5% of the shares (and voting rights) in the company; and (ii) been employed by the company

A company will be a trading company if it does not have any substantial (defined as exceeding 20%) non-trading activities determined by looking at the company`s asset base, non-trading income and resources spent on non-trading activities. Whilst ABL holds a large cash balance which might be regarded as non-trading in nature, little interest income is generated or resources spent in managing this asset so `in the round` it is unlikely that this would jeopardise ER.

Whether Bob is able to purchase your shares depends upon whether he has the required funds or is able (and willing) to borrow any shortfall. Since ABL is a close company employing Bob he could claim an income tax deduction for interest paid on a loan used to buy the shares. Ultimately, however, it is likely that such a loan would need to be repaid from taxed income so this could be an expensive option.

If Bob buys your entire shareholding but pays in instalments, the general CGT rule is that the entire CGT liability remains payable by the due date (although if any consideration becomes irrecoverable the chargeable gain can be adjusted accordingly). You could apply to HMRC to pay the liability in instalments (providing the instalment period exceeds eighteen months; at least 50% of an instalment is used to pay CGT (until all is paid); and all the CGT is paid within 8 years). Interest will be charged on any CGT paid after the `normal` due date. You would also bear the commercial risk of non-payment (which may rise with the increased overseas competition). This would not therefore be advisable.

Because the proceeds will exceed £1,000 Bob would need to pay stamp duty at the rate of 0.5% to HMRC.

Conclusion
A direct sale would be the simplest route providing after tax proceeds of £138,200 (£150,000 - £11,800), which is more than sufficient to set up your sole-trader business.

Purchase of shares by ABL
Alternatively, as ABL has sufficient cash (and distributable profits) it could buy-back your shares. This is important as the shares need to be paid for when purchased (deferred consideration in the form of a loan account would almost certainly not constitute payment).

In this case ABL would need to pay stamp duty at the rate of 0.5% to HMRC.

Taxation Consequences
Default position
The default position is that you will be deemed to receive additional dividend income of £145,000 (£150,000 less the original subscription price of £5,000 (£10,000/2)). This is added to your other income for the tax year of receipt and is subject to marginal income tax rates.

Appendix I shows that your current income tax liability for 2020/21 is £4,016. Assuming the buy-back occurs before 10 July 2020 (see below) and you take the £50,000 dividend due on 6 July 2020 this will rise to £58,478.

This is because: (i) your £2,000 dividend allowance will already be used against the £50,000 dividend; (ii) your total income now exceeds £125,000 so your personal allowance will not be available; and (iii) as your taxable income will exceed £150,000 dividend income in excess of this will become subject to additional rate tax of 38.1%.

A capital loss of £15,000 would also arise (£5,000 (original subscription price) less £20,000 (original cost paid)). As there are no current tax year chargeable gains, this loss could only be carried forward for use against any future chargeable gains that may occur.

Conclusion
With a dividend, your net of tax funds available to invest in the new business fall to £95,538 (£150,000 – £54,462 (£58,478-£4,016)). This is less than you require so you would need to find the balance of the funds from elsewhere, such as borrowings.

You could waive the dividend due on 6 July 2020 but would then presumably want commercial compensation for this in the form of additional proceeds. This would lead to the same result as above.

Capital Gains Tax (CGT) treatment
If specified conditions are satisfied, however, the payment from ABL would automatically be treated as falling under CGT rules. This is better because of the availability of ER and the annual exempt amount and would again result in a CGT liability of £11,800, giving sufficient funds to commence your new business.

The specified conditions are as follows:

Conditions for ABL
ABL needs to be an unquoted trading company, which it is.

The share buy-back must be wholly and mainly for the purpose of benefitting ABL`s trade. HMRC guidance clarifies that this includes circumstances where there is a disagreement between shareholders over a company`s management that is having or will have an adverse impact on the company`s trade. Your current disagreement with Bob would appear to satisfy this condition. HMRC normally expects the departing shareholder to sever all ties, including ceasing to be a director and selling all their shares (apart from a small holding up to 5%).

Conditions for yourself
- You need to be UK resident in the tax year when the buyback occurs, which you will be.
- You will need to `substantially reduce` your shareholding. This means that there needs to be at least a 25% reduction in both your shareholding and your interest in ABL`s distributable profits after the buy-back. The former is calculated by comparing the fraction of the nominal value of all the issued shares held by yourself before and after the buyback. Providing you sell all of your shares you will satisfy this condition.
- You must not be connected with the company immediately after the purchase. This means that after the buy-back you must not own more than 30% of the issued shares, loan capital or votes. Again, if you sell all of your shares you will satisfy this condition.
- You must have owned the shares for at least five years before the date of the buy-back.

With regards the last condition you will not have held your shares for at least five years until 9 July 2020 so a buy-back before 10 July 2020 will produce a dividend and is therefore unlikely to be beneficial. It is noted, however, that by implementing the buy-back either before or after this date you can effectively choose whether this will be taxed as income or capital (see trading loss section later).

Clearance Procedure
Prior to any share buy-back prudence dictates that an advance clearance should be sought from HMRC to establish the tax treatment. Simultaneously clearance can be sought that the `transactions in securities` anti-avoidance provisions will not apply (because the buy-back is for bona fide commercial purposes) and will not therefore disadvantageously be taxed as dividend income under those provisions.

Conclusion
It would be more favourable to secure CGT treatment by ensuring the buy-back occurs after 9 July 2020. This would give the same position as a direct sale (ie providing after tax proceeds of £138,200).

Part II

New Sole-trader Business
As agreed during our telephone conversation on 30 April 2020 this section is based upon using an accounting date of 30 April for the new business with the first accounts prepared for the period ended 30 April 2021. This will permit a discussion of the main points although it should be noted that the actual accounting date to be used may require further analysis.

Basis of Taxation and Accounting Date
As a sole trader you will be liable to income tax on your tax adjusted profits irrespective of whether or not these are drawn. Tax adjusted profits are simply accounting profits adjusted for certain required tax adjustments (e.g. for the private use of any business assets or capital allowances on qualifying capital expenditure (see later)).

Rather than using accruals accounting, it is possible for businesses with annual receipts below £150,000 to prepare accounts using the cash basis (i.e. essentially business income received less allowable expenses paid (including capital expenditure (except cars) qualifying for capital allowances)). However, loss relief against other income (see later) is not permitted using the cash basis so it is unlikely that this would be beneficial.

As your period of account will not necessarily coincide with a tax year, special rules are required to link them. The basic rule is that for each tax year a trader will be taxed on profits for the period of account ending in that tax year. In the opening years of a business, however, special rules apply such that profits can be taxed more than once. Appendix II shows, using the assumptions stated, your assessable profits for the tax years 2020/21 to 2023/24 inclusive.

Capital Allowances
Tax relief for the purchase of equipment and office furniture is given via capital allowances. If you are VAT registered (see later) you will be entitled to a 100% annual investment allowance (`AIA`) amounting to £100,000 (£120,000 x 100/120) which is deducted in arriving at taxable profits for the period in which the expenditure is incurred. Please note only expenditure up to £1,000,000 per year qualifies for this allowance (providing additions are purchased by 31 December 2020, falling to £200,000 for additions from 1 January 2021).

If any other assets you own are introduced to the business at commencement an AIA could be claimed based on their market value at the start of the business. This is with the exception of cars which are not eligible for AIA but instead are either entitled to a writing down allowance of either 18% or 6% (depending upon the car`s CO_2 emission) or even a 100% first year allowance (if the CO_2 emission is very low or electrically propelled). Please note that any capital allowances will be restricted for any private use of the underlying assets.

Initial Trading Loss
Appendix II (on the same assumptions as before and that you are VAT registered) also shows that the AIA claim creates a trading loss for the 2020/21 tax year amounting to £80,500.

There are four ways in which this loss can be used.

1 Carrying it forward to relieve the first available future trading profits of the same trade.
2 Setting it against total income (eg your salary and dividends (including any buy-back dividend)) arising in 2020/21 and/or 2019/20.
3 Setting it against any chargeable gains arising in 2020/21 and/or 2019/20 (following a claim under 2) above).
4 Setting it against total income arising in 2017/18, 2018/19 and 2019/20 (against earliest year first) under special rules for the first four years of a business.

There is an overall limit on the amount of relief that can be deducted from total income in any tax year of the greater of (i) £50,000 and (ii) 25% of (broadly) total income less any gross personal pension contributions. This restriction does not, however, apply where relief is extended to chargeable gains.

The loss can only be relieved once, so the decision will need to be determined by cash-flow (i.e. obtaining relief as soon as possible); the marginal income tax rate at which relief will be obtained; and saving personal allowances (because loss relief cannot be restricted).

A claim under 1) will initially carry forward the £80,500 loss from 20/21 and set it against trading income of £3,167 in 21/22 wasting the personal allowance. Then £44,000 of the remaining loss will be offset in 22/23 again wasting the personal allowance but saving 20% tax on £31,500 of profit. This then leaves £33,333 of loss to offset against the £60,000 trading profit in 23/24 saving 40% tax on £10,000 of profit and 20% tax on the balance covered by the loss and no waste of personal allowance.
If the CGT treatment applies for the share buy-back (i.e. this occurs after 9 July 2020), because there are more dividends being taxed at the higher dividend rate of 32.5% for 2017/18 and 2018/19 option 4) rather than option 2) would probably be preferred. This would also obtain the earliest possible use of the loss and avoids wasting any personal allowances. It should be noted that loss relief under option 4) would be restricted to £50,000 for 2017/18 (being greater than £15,375 ((£11,500 (salary) + £50,000) x 25%).

Following a claim under 2) for 2020/21 relief could be extended under 3) to offset the residual £30,500 loss (£80,500-50,000) against the chargeable gain. This extended claim, however, would only obtain relief at the rate of 10% which is lower than if a claim is wholly made under 4) so is less preferable.

If the share buy-back results in a dividend (i.e. occurs before 10 July 2020) a claim under 2) could result in the loss being offset against total 2020/21 income of £199,167 but relief would be restricted to £50,000 (being greater than 49,792 (£199,167 x 25%)). The balance of £30,500 (£80,500 - £50,000) could then be relieved against 2019/20 income of £62,500.

This would obtain a reduction in tax liability of £24,463 ((2020/21 - £50,000 x 38.1%) + (2019/20 - 12,500 x 32.5% + 18,000 x 7.5%)). Whilst this is better it is to be noted that the additional income tax savings will be considerably less than the difference of £42,662 between the share buy-back being taxed as a capital sum (£11,800) or as an income distribution (£54,462).

Conclusion
To obtain tax relief at a reasonably high tax rate as soon as possible, the preferred loss relief is to carry back against total income for 2017/18 and 2018/19 generating tax refunds. The availability of the trading loss would not alter the earlier conclusion that the share buy-back should occur on or after 10 July 2020 to obtain CGT treatment.

Possible Future Strategy
The business could also be started as a limited company. In this event any initial trade losses would only be available to carry forward against any future profits made by the company and could not be available for personal use as described above. This would therefore be a good reason to commence on a sole trader basis.

As profits increase going forward the business could be incorporated as a limited company to take advantage of lower corporation tax rates. A similar remuneration strategy to that currently adopted by ABL (i.e. low salary to minimise Class 1 NIC with top-up dividends set at levels around the higher rate tax threshold) could then be adopted.

Deferral of Gain
Enterprise Investment Scheme reinvestment relief maybe available if the business is incorporated within three years of disposing your ABL shares. Broadly upon incorporation to the extent that new shares are subscribed in an unquoted company carrying on a qualifying trade from a permanent UK establishment the original gain (ie up to £118,000) could be deferred until there is a `chargeable event` (eg when the EIS shares are disposed of themselves).

This is not, however, a permanent relief, the CGT arising on the original gain is merely deferred until the tax year in which a chargeable event occurs. It would, however, provide a cash flow benefit. ER would be available on any deferred gain becoming chargeable as the original ABL share disposal qualified for this relief.

VAT
You will also need to consider whether or not to register for VAT purposes. Once your cumulative turnover for the past twelve calendar months (or less from commencement) exceeds £85,000 you will have to register. Before this you will have the choice of registering.

It is only by registering that you will be able to recover the VAT incurred on expenditure (including £20,000 on the initial assets). Usually a trader can only register from the date trading commenced, which may be after you have bought the initial assets. Because these assets will have been bought for business purposes, providing they still exist at the date of registration and no longer than four years has elapsed since their acquisition, you will still be able to reclaim the VAT on this `pre-trading expenditure`.

From the date you register, however, you will also need to account for VAT at the standard rate of 20% on any sales you make. Because you will be dealing with other businesses which are also presumably VAT-registered they will be able to recover the VAT you charge. This would therefore not represent an additional cost to them, which they may have sought to pass back to you via a reduction in your prices.

To permit early recovery of the initial VAT on expenditure, apart from the additional small amount of administrative work involved it would appear therefore that there would be no strong reason not to VAT register from the commencement of the new business.

Appendix I

Anticipated 2020/21 Income Tax liability

Current position

	£	
Salary (to 31/07/2020)	4,167	(£12,500 x 4/12)
Dividend	50,000	
Personal allowance	(12,500)	
Taxable income	41,667	
Income tax:		
2,000 x 0%	nil	
35,500 x 7.5%	2,662	
4,167 x 32.5%	1,354	
	4,016	

With additional dividend

	£
Salary	4,167
Dividend	195,000
Personal allowance	nil
Taxable income	199,167
Income tax:	
4,167 x 20%	833
2,000 x 0%	nil
31,333 x 7.5%	2,350
112,500 x 32.5%	36,562
49,167 x 38.1%	18,733
	58,478

Appendix II

Assessable Profits

Before capital allowances

Assumptions:
Trading commences on 1 September 2020.
First accounts are made up to 30 April 2021 and then annually thereafter.
First year`s profits are £12,000 and £60,000/year thereafter.
There are no privately owned assets introduced to the business.
Sole trader business continues to 30 April 2023.

Taxable profits:

Accounting period		£
Period ended 30 April 2021	12,000 x 8/12	8,000
Year ended 30 April 2022	(12,000 x 4/12) + (60,000 x 8/12)	44,000
Year ended 30 April 2023		60,000

After capital allowances

A loss of £92,000 (£8,000 - £100,000) arises for the period ended 30 April 2021.

Assessable trading profits:

Tax year			
2020/21		(92,000)x 7/8	(80,500)
2021/22	(first 12 months)	Note 13,167	
2022/23			44,000
2023/24			60,000

Note 1
For 2021/22 profits will be £3,167 (92,000 (loss) less £80,500 (already used) plus £14,667 calculated as 4/12 x £44,000).