Report

To: Andrea Atkins

From: Camilla Cowley

Date: 8 May 2020

Subject: Disposing of your shareholding in A & B Footwear Limited and starting your new graphic design business.

Introduction

This report has been written following our meeting dated 24 April 2020 and our subsequent phone call on 30 April 2020. The report discusses your options and the associated tax implications for disposing of your shareholding in A & B Footwear Limited and starting your new graphic design business.

This report has been prepared solely for use by you. We do not accept any liability to a third party who relies on this report.

Once you have had the chance to read and digest this information, I would be happy to discuss any questions you may have.

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3. Abbreviations

- A&B/ the Company = A & B Footwear Limited
- CGT = Capital Gains Tax
- CPOOS = Company Purchase of Own Shares
- CT = Corporation Tax
- ER = Entrepreneurs Relief
- IT = Income Tax
- NIC = National Insurance Contributions
- SD = Stamp Duty
- You = Andrea Atkins

2. Executive Summary

- Disposing of your shareholding to Bob will result in a capital gains tax charge of £11,800 for you. It will also require a significant cash outlay from Bob, which he may not have the funds to facilitate.
- A Company Purchase of Own Shares ('CPOOS'), whereby the Company purchases your shareholding, will enable Bob to become the sole shareholder without paying any cash for the shares. Where the CPOOS is undertaken after 10 July 2020, a capital gains tax charge of £11,800 will arise on you. Based on the tax saving for Bob and the greater commercial viability of this option I would recommend undertaking a CPOOS after 10 July 2020.
- By commencing your new business venture as a sole trader, you will be entitled to numerous loss reliefs including the most beneficial of which is early years trade loss relief. This will entitle you to a tax repayment of approximately £17,588 from the losses that you will incur in your first period of trading.
- Trading through a Limited Company provides limited liability protection. However, losses can only be relieved by carrying them forward, greatly reducing the marginal tax saving. Therefore, it is recommended that you start your business as a sole trader and claim early years trade loss relief.
- You should consider registering for VAT to reclaim £20,000 of costs on your initial equipment purchases.

3. Disposing of your shareholding in A & B Footwear Limited

There are three main options for disposing of your shareholding in A&B including selling the shares to Bob, selling the shares to an external third party and the company purchasing the shareholding from you. I will discuss each option and its tax implications in turn.

3.1. Disposing of shares to Bob

Under the Articles of Association of the Company, you are required to give notice to the Directors of the Company of your intention to sell your shares to anyone who isn't already a member of the Company. After giving such a notice, it will be possible for you to dispose of your shareholding to Bob at either a price agreed between the two of you, or failing the agreement of a fair price, at market value which I understand is £150,000.

Disposing of your shareholding to Bob would be a disposal for capital gains tax purposes and would give rise to a chargeable gain. The gain arising would be £118,000 after the deduction of your annual exempt amount. The gain will be taxed at either 10% or 20%, and the amount will be due for payment by you on 31 January 2022 where the transaction takes place by 31 July 2020.

This gain may be eligible for Entrepreneurs Relief which is a relief that lowers the tax charge for 20% to 10% up to lifetime limit of £10 million. This relief is available where:

- You own 5% or more of the share capital, voting power and income rights on a winding up;
- The company is a trading company;
- You are an employee or office holder of that company; and

all of the above three conditions have been satisfied for a period of at least two years. As you own 50% of the shares and have been an office holder of the Company for more than two years, the first and the last condition are met.

However, HMRC will use a ‘20%’ test to determine whether the company is a trading company. This test seeks to ensure that no more that 20% of turnover, balance sheet assets and management time relates to non-trading or investment activities. There is a risk that the high cash balance available in the company may cause HMRC to deem the Company as a non-trading entity. The cash balance represents over 20% of the Company’s net current assets, which may cause it to fail to 20% test. However, this may be able to be overcome by re-valuing the assets on the balance sheet and including the price of any goodwill. HMRC are also likely to take an ‘in the round view’ where they will look at the Company as a whole and its history, and I suspect they will see that the activities of the Company are clearly trading. Therefore, from hereon I will assume that ER will be available.

As a result of ER being available, the gain on the disposal of the shares will be £11,800 (Appendix 1).

The Articles of Association permit you to decide a value between yourself and Bob. Should Bob purchase the shares for less than market value, the gain will still be calculated in the same way using the full market value for proceeds. However, part of the chargeable gain may be able to be deferred using gift relief, which will reduce part of your gain now and roll the cost against the base cost of the shares for Bob. This will require a joint election between yourself and Bob. However, agreeing a reduced price may result in part of the shares being regarded as Employment Related Securities, which would result in the difference between the price and the market value being charged to income tax for Bob. Therefore, Bob may not wish to agree to this as it would be tax inefficient for him.

I would not recommend that a price higher than market value is agreed, as anything above market value may be charged to income tax on you through tax avoidance legislation known as Transactions in Securities, which will result potentially a very high tax charge.

Bob will be liable to pay Stamp Duty on his acquisition of the shares at a rate of 0.5% of the consideration paid. Therefore, based on a market value consideration, the charge will be £750 which will be due and payable within 30 days of the transaction. There will be no income tax or NIC consequences for Bob if shares are disposed of for market value consideration.

The main difficulty that you may face with this option is that Bob will be required to fund the transaction. This will involve a substantial sum of money and it may not be sensible to assume that this level of funding would be available to him. Although Bob could borrow this money from a bank or from the Company, there may be more tax efficient options.

3.2. Disposing of shares to a third party

If Bob does not wish to purchase the shares, the Articles of Association permit you to sell them to a third party within 12 months. This transaction will therefore me likely to take place at market value and the tax implications of this will be the same for you as disposing of your shareholding to Bob, producing a capital gains tax charge of £11,800.

The purchaser of the shares will be liable to a Stamp Duty charge as above. If the purchase is for any reason undertaken at a reduced price, there will be no Employment Related Securities issues where the purchaser is an external third party, However, commercial it is likely to be difficult to find a buyer who will purchase the shareholding at its current market value given that the profits of the Company may well decrease in the future. It is also my understanding that Bob wishes to carry on the business alone, and therefore he is unlikely to wish for a third party to purchase the shareholding. As a result of this and given that there is no tax benefit to you of this option, I would recommend considering other options.

3.3. Disposing of shares through a company purchase of own shares

Instead of selling the shares to Bob or a third party, you could instead sell your shareholding back to the Company under a company purchase of own shares ('CPOOS').

Usually, a purchase of own shares will be regarded as an income distribution unless certain conditions are met. Through an income distribution, your disposal of your shareholding will be regarded as a dividend, and you will be charged to both income tax and capital gains tax on your disposal.

The deemed dividend would be £145,000, which would be chargeable to income tax at rates of up to 38.1%. Therefore, this would cause a significant tax charge and drastically reduce the net cash you will have to use to set up your business. There will be a capital loss as a result of the disposal which will be £15,000, however this benefit will be largely outweighed by the high income tax charge.

Instead, where the Company meets the following conditions, it will be eligible for capital treatment:

1. The Company is an unquoted trading company that is not a 51% subsidiary of a quoted company
2. You are a UK resident
3. You have owned the shares for a period of 5 years or more prior to disposal
4. Your subsequent interest in the Company is reduced by at least 25% of your previous interest
5. You are not connected with the Company following the purchase
6. The purchase of shares by the Company is for the benefit of the trade

As you can see, conditions 1 and 2 above are clearly met. As at 10 July 2020, you will have owned the shares for a period of 5 years. Therefore, so long as the repurchase is undertaken after this date, condition 3 will be met. You are disposing of your entire shareholding, therefore the reduction in your shareholding will be 100% meaning condition 4 is met. As you will be entirely removed from the Company as a shareholder and director following the repurchase, condition 5 is also met.

Lastly, where there is a disagreement between the shareholders over the management of the Company which is expected to have an adverse effect on the Company's trade, condition 6 will be met. Based on the information you have provided regarding the dispute between yourself and Bob and the reasons for leaving the Company, I therefore believe that condition 6 will also be met.

As a result of undertaking a CPOOS post 10 July 2020, the purchase of the shares from you by the Company will be charged to capital gains tax only and there will be no income tax charge. As a result, the charge to capital gains tax on this disposal will be £11,800 (Appendix 3). ER was again available here to reduce the tax charge from 20% to 10%.

It is important to note that for capital treatment to apply, there must be sufficient reserves within the Company to facilitate the repurchase. As the amount of distributable reserves within the Company is far greater than the market value of the shares, this condition should be satisfied. As well as this, the Company will be required to pay cash for the shares to you when purchased in order to secure capital treatment. Lastly, the Company must have requisite power in its Articles of Association to undertake the CPOOS. From reading the Articles of Association, I understand that you are entitled to dispose of the shares in any manner you think fit after they have been offered to Bob, therefore this should permit power to undertake the CPOOS.

The Company may be required to pay stamp duty on this purchase. For Bob, there will be no cash outlay as the purchase will be funded by the Company. The shares can be cancelled by the Company following the purchase, meaning Bob will be the sole shareholder of the Company as desired.

In summary, there are three main options available to you for selling your shareholding in the Company. However, in order for Bob to continue the Company as the sole shareholder as desired, to achieve this it will require Bob purchasing your shareholding or the Company purchasing your shareholding, as opposed to a third party. The tax treatment for you under either option is the same, and you will be charged to capital gains tax od £11,800. However, a CPOOS will save Bob a considerable cash outlay and is therefore likely to be the most commercially viable option. In order to ensure that capital treatment is given as opposed to income treatment, it will be necessary to delay the repurchase to 10 July 2020, but this is still earlier than 31 July 2020 as you require. A CPOOS under the capital treatment will save a considerable amount of tax than under the income treatment. Therefore, I would recommend that a CPOOS is undertaken after 10 July 2020.

For completeness, it should be noted that the VAT and inheritance tax consequences of a CPOOS or Bob purchasing the shares are the same and will not impact this decision.

4. Setting up your new business

There are broadly three main options for setting up your new business, being a Sole Trade business, a Partnership/LLP or a Limited Company. I will discuss each option and the tax implications in turn.

4.1. Sole Trader

By setting up as a sole trader, you will not have limited liability protection. Therefore, your personal wealth will be at risk should the business default or any issues arise. I would encourage you to take out insurance to help minimise the financial impact of any such issues arising in the future.

Upon commencing the business, you will be charged to tax during the tax year 2020/2021 on your taxable profits from 1 September 2020 when you plan to commence trading to 5 April 2021. As such, approximately £7,000 will be taxable in the tax year 2020/2021 based on your current forecasts. As a result of having a 30 April year end, 11 months of your profits will be charged to income tax twice in the early years of trading which will be recorded as overlap profits. These profits will be relieved in the future when you cease to trade.

As a result of running a sole trade business, your full profits of each period will be charged to Income Tax. Therefore, profits during the first year of trading should be covered by your personal allowance, assuming you receive a reduced amount of profit from A&B for your final few months of work. As you are aware, the personal allowance is currently £12,500, so all profits below this level will not incur an income tax charge.

However, in subsequent years when trade increases, your tax charge will increase. Based on a £60,000 profit per year, your income tax charge would be £11,500 (Appendix 4). As you are aware, you will also be charged to Class 2 and Class 4 NIC on this income.

However, it is important to consider the cost of the equipment you intend to buy and how this may impact your costs. From an initial review of the costs of your equipment, it seems that the costs may qualify for the Annual Investment Allowance. This is an allowance that allows the full value of the cost to be deducted against profits in the period it is purchased, up to a maximum value of £1 million. Therefore, should you purchase this equipment when you commence trade, this will dramatically change your profit position and will result in a loss of approximately £113,000. This loss can be relieved in multiple ways and can be tailored to reduce your tax charge at the highest possible marginal rate.

The loss can be relieved by setting it against net income of the tax year of the loss or the preceding tax year. As you will not have any net income in the 2020/21 tax year, it can be used against any income you had from A&B during the 2019/20 tax year. However, it is assumed that this amount will be small and should be covered by your personal allowance anyway.

After making this claim, it would then be possible to use the remainder of the loss against any gains that occurred in the tax year of the loss or of the preceding tax year. As such, the loss could be used against the gain arising on the disposal of your shares. As a result of using the two claims together, you could be entitled to a tax repayment of approximately £13,175 (Appendix 6). This is a considerable tax saving.

Alternatively, you will be entitled to claim early years trade loss relief. This permits any losses arising in your first four tax years of trade to be carried back to the previous three tax years, taking the loss back to the earliest year first. As such, you would be able to save tax a higher income tax rates from your earnings from A&B. This relief is restricted to a the greater of £50,000 and 25% of your adjusted total income in a tax year (being your income less the gross amount of any personal pension contributions). Under this route, you would have a total tax saving of £17,587.5. Therefore, you will receive a greater tax saving from early years trade loss relief than the previous option. As such, I would recommend claiming early years trade loss relief. This can be done through your income tax return.

From a VAT perspective, you will not be required to register for VAT until your turnover in the previous 12 months reaches £85,000. However, it is possible to voluntarily resister for VAT. By voluntarily registering, you will charge VAT on your services, however as you are selling your services to businesses, it is likely that they will already be VAT registered and can reclaim the VAT cost. Once registered, you will be able to reclaim the VAT costs of the equipment that you have purchased for the business. This will result in a reclaim of approximately £20,000 of VAT (£120,000*1/6).

Therefore, I would recommend that you register for VAT. This can be done by submitting for VAT7 to HMRC. You should note that you will be required to prepare VAT returns, however you will be eligible for the annual accounting scheme which will reduce your VAT burden and enable you to prepare a single annual VAT return. You will not be required to comply with the conditions of making tax digital, which requires you to hold your records electronically, until your turnover reaches £85,000.

In addition to this, you will also be using part of your home in your business. Relief can be claimed for the actual costs incurred in using this section of your home, or through a flat rate cost scheme. We can discuss this in further detail once you have calculated the costs of using this part of your home to decide which option would be most beneficial. However, you should be aware that using part of your home for business use may impact your capital gains tax position when you sell your house in the future and may mean that a capital gains tax charge arises on disposal. If the spare room is small in comparison to the rest of the house, this charge may be covered by your annual exempt amount in the year of disposal. You should note that residential properties are taxed at higher capital gains tax rates of 18%/28%. Therefore, unless the flat rate scheme gives you significantly less of a deduction, I would recommend you claim this to reduce the future gain on the disposal of your house.

You should also note that you will be eligible for the cash basis of accounting, as your income is below £150,000. This will allow you to record income and expenses when the cash is received. This may be of benefit to you and we can discuss this in more detail should you wish to.

4.2. Partnership/LLP

Alternatively, it may be possible to set up your business as a Partnership. The tax consequences of this are similar to that of a sole trader. However, as I understand you wish to start this venture alone and are not considering working with anyone else. Therefore, a Partnership would not be suitable option.

4.3. Limited Company

Instead, you could run your business through a new Limited Company. This will allow you to benefit from limited liability protection.

As you may be aware from your time at A&B, trading through a Limited Company can allow you to extract cash from the Company in a tax efficient manner. For example, profits of could be drawn party as salary and party as dividend after a corporation tax charge of 19%. This best is facilitated by taking a salary up to the lower earnings limited for NIC and the remainder as dividends. However, with your current level of projected profits, this it does not seem that you will benefit from this at present. A corporation tax charge of £11,400 would arise within the company on the profits earnt, which is broadly in line with the income tax charge you would pay as a sole trader. Therefore, after you have paid income tax, the charge would be greater than if you were a sole trader.

Under a company structure, you would no longer be liable to Class 2 and 4 NIC, but instead Class 1 and 2 NIC. However, no NIC will be payable where your salary does not exceed the lower earnings limit of £8,632.

The VAT consequences for a sole trader would remain the same for a limited Company. You would also be entitled to Business Property Relief which would reduce the inheritance tax charge on a disposal of your shares to £nil where the necessary conditions are met. This is the same as for a sole trade business and therefore should not impact this decision.

However, the loss relief available to a Company would only permit the losses to be carried forward against future profits. No carry back facility would be available against your net income in prior years. As such, you would only be saving tax at corporation tax rates of 19%, which will dramatically reduce your saving as compared with early years trade loss relief.

Therefore, in your first year of trading, to benefit from early years trade loss relief, I would encourage you to start your business as a sole trader. If in future years profits increase, should you wish to, it may become more tax efficient to incorporate in order to benefit from more tax efficient profit extraction. You will also then be able to benefit from limited liability protection. However, I would not recommend that you trade through a Limited Company now, as early years trade loss relief will produce the greatest tax saving for you.

5. Appendices

Appendix 1 – CGT on disposal of shares to Bob

Proceeds	£150,000
Less base cost:	(£20,000)
Gain	£130,000
Annual exempt amount	(£12,000)
Gain chargeable	£118,000
Tax @ 10%	£11,800

It has been assumed that your basic rate band will be fully used up by your salary and dividend payments in the tax year.

Appendix 2 – CPOOS income treatment

Proceeds	£150,000
Less: original subscription price	(£5,000)
Deemed dividend	£145,000

Original subscription price	£5,000
Less: actual cost	(£20,000)
Capital loss	£15,000

Appendix 3 – CPOOS capital treatment

Proceeds	£150,000
Less: cost	£20,000
Capital gain	£130,000
Less: annual exempt amount	(£12,000)
Gain	£118,000
Tax at 10%	£11,800

Appendix 4 – Income tax charge on new business

Profit	£60,000
Less: personal allowance	(£12,500)
Net income	£47,500

Tax:

37,500 @ 20%	£7,500
10,000 @ 40%	£4,000
Total	£11,500

Appendix 5 – Loss position at start of trade

Profit	£7,000
Less: AIA	(£120,000)
Loss	£113,000

Appendix 6 – Loss relief 1

Salary in 2019/20:

Salary	£12,000	
Dividend		£50,000
Less: Loss		(£50,000)
Net Income	£12,000	
Tax =	0	

(Fully covered by personal allowance)

Tax saved:

£37,500 @ 7.5% = £2,812.5

£12,500 @ 32.5% = £4062.5

Total: £6,875

Remainder used against capital gain before annual exempt amount: £130,000 – (£113,000 – 50,000) = £67,000

Gain	£67,000

Less: AEA	£12,000
Gain	£55,000
Tax @ 10%	£5,500

Tax saving £11,800 - £5,500 = £6,300

Total saving: £13,175

Appendix 7 – Early years trade loss relief

(Based on current tax rates for illustrative purposes only.)

Y1-2

Salary	£12,000	
Dividend		£50,000
Less: Loss		(£50,000)
Net Income	£12,000	
Tax =	0	

(Fully covered by personal allowance)

Tax saved each year:

£35,500 @ 7.5% = £2,662.5

£12,500 @ 32.5% = £4062.5

Total: £6,725

Year 3

Salary	£12,000	
Dividend		£50,000
Less: Loss		(£13,000)
Net Income	£12,000	£37,000
Less PA	(£12,000)	(£500)
	£nil	£36,500

Tax:

2000 @ 0%

34,500 @ 7.5% = £2,587.5

Tax saved: £6,725 - £2,587.5 = £4,137.5

Total saving years 1 – 3 = £4,137.5 + £6,725 + £6,725 = £17,587.5