The Chartered Institute of Taxation

Application and Professional Skills

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Suggested solution

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Acquisition of new art gallery business and related issues

Introduction
This report considers the ways in which the acquisition of the new gallery business (the 'gallery') could be structured.

Our analysis relies upon the information provided by you in relation to the gallery and in particular your profit and expenditure forecasts.

This report is for the benefit of Sonya Style only. The details and advice contained should not be relied upon by any other party.

It is based on 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.

Executive Summary
Our overall recommendation is that the gallery is purchased and run through AA Construction Ltd ('AAL').

As a result of the earlier trade and asset sale by AAL, sufficient funds are available in the company to purchase and set-up the gallery, without the need for any external borrowings. This is not the case with most of the other options. This option also avoids a personal capital gains tax ('CGT') liability of £36,867 which would be incurred if the funds were extracted from AAL to purchase the gallery in alternative ways.

Rollover relief can be claimed to defer £24,030 of the additional CT charge arising from the sale of AAL's former trade and assets. A tax efficient remuneration strategy based upon low salary and dividends could also be adopted. If you are able to maintain total income extracted below the higher rate threshold this would mean a marginal income tax rate of 8.75% could be achieved.

The principal disadvantage of purchasing the gallery through AAL would be that upon the eventual disposal of AAL a comparatively low base cost of only £20,000 would be available to set against any future chargeable gains arising.

Structuring the new business
There are three basic structures to consider for purchasing and operating the gallery:

- As a sole trader
- Via AAL
- Via a newly formed limited company ('Newco`)

Before examining each of these there are some issues that need to be considered irrespective of the eventual structure adopted.

Preliminary Matters

Impact of sale of assets by AAL

Any additional CT payable on the sale of AAL's trade and assets on 31 March 2023 will reduce the funds available to purchase and set up the gallery.

Appendix I shows that a trading profit of £100,000 on the disposal of AAL's goodwill, chargeable gains totalling £137,000 and a balancing charge of £100,000 arose. An additional CT liability of up to £64,030 (£337,000 x 19%) will therefore arise for the accounting period ('AP') ended 31 March 2023, payable (with any CT on trading for that period) by 1 January 2024.

Appendix II shows that after providing for this additional CT maximum funds of £410,970 would be available for use in setting up the gallery.

This sale should be regarded as a transfer of a going concern (`TOGC`) and therefore no VAT will be chargeable.

Initial funding requirement

Appendix II shows the initial funding requirement for purchasing the gallery will be £402,250.

Because the freehold property is not subject to an option to tax election no VAT will be chargeable on its purchase. The VAT status of the remaining assets depends upon whether the gallery purchase will be a TOGC. If not VAT of £6,000 ((£55,000 - £25,000 (goodwill, being an intangible asset, is excluded from charge)) x 20%) becomes payable, increasing the initial funding requirement.

The only potential problem relating to obtaining TOGC treatment is that there should be no significant gap in the trading pattern before or immediately after the purchase. HMRC guidance indicates that a short period of closure for 3-4 weeks for refurbishment should be acceptable. If there is any doubt slightly delaying the refurbishment may be helpful.

If VAT is charged incorrectly this will not be recoverable. Conversely if no VAT is charged when it should have been a VAT invoice will be required to enable its recovery. Appropriate clauses should therefore be included in the purchase agreement covering these matters.

As the seller is VAT-registered and, as seems most likely, the TOGC provisions apply, they will invariably require the purchaser to be, or become, VAT-registered upon the transfer of the business.

The remainder of this report assumes no VAT becomes payable, giving a funding requirement of £402,250.

Forecast Results

Whilst profitability is expected to increase to £90,000 by the year ended 31 March 2026 as shown in Appendix III, after claiming allowable pre-trading expenditure and capital allowances, a forecast trading loss of £100,000 is expected for the initial period to 31 March 2024.

Purchase as a sole trader

General

The simplest structure would be to own and run the gallery as an individual on a sole trader basis. Whilst this gives lower running costs and easier administration, your personal assets might be at risk in the event of business failure.

You will pay income tax and Class 4 national insurance contributions ('NICs') at marginal rates on all your profits irrespective of whether they are withdrawn from the business. 40% income tax will apply on profits exceeding £50,270. Class 4 NICs will be 10.25% on profits between £11,908 and £50,270 and 3.25% on profits exceeding £50,270.

You will also pay Class 2 NICs at a fixed weekly rate (£3.15), although for the initial period (because profits are less than £6,725) you will have the option of whether or not this is paid. Class 2 NIC count towards certain state benefits (including the state retirement pension), so as the charge is modest, if there is a gap in your NIC record it would be advisable to pay these contributions.

To ensure Class 2 NIC is properly credited for benefits purposes your self-employment would need to be registered with HMRC.

Extraction of funds from AAL
If you wished to operate as a sole trader the available funds within AAL would need to be extracted to allow you to personally acquire the gallery.

Extraction via additional salary would result in very high marginal income tax rates (45%) on a significant portion as well as large NIC liabilities for both yourself and AAL. This approach is therefore not recommended. Because AAL has ceased trading it would also not be possible to obtain any corporation tax relief for the salary expense generated.

Extraction by way of a dividend would be better but would also result in high marginal tax rates (39.35%) and would therefore also not be recommended.

Alternatively, as AAL would no longer be required it could be dissolved either by applying to Companies House to have the company struck off; or by passing a winding-up resolution and appointing a liquidator. A strike-off of AAL would be much cheaper. However, because total distributions would exceed £25,000 the vast majority, would be subject to 39.35% income tax. This method would not therefore be recommended.

Whilst a liquidator's fees would be expensive (say £10,000) a formal liquidation would mean that any distributions paid would be capital (rather than income) distributions, accessing more attractive CGT rates. If paid within three years of the cessation of AAL's trade business asset disposal relief (`BADR`) could be claimed reducing the CGT rate applying from 20% to 10%.

BADR can be claimed because in the 2 years prior to AAL ceasing to trade the company was:
- (i) your personal company (broadly you owned at least 5% of AAL`s shares, voting rights etc);
- (ii) a trading company and;
- (iii) your employer

A capital distribution following the appointment of a liquidator would therefore be the recommended route to extract the funds from AAL.

Funds distributed on liquidation
The distribution would result in a CGT liability of £36,867 ((£380,970 (£410,970 - £10,000 (liquidator`s fees) - £20,000 (inherited probate value)) - £12,300 (annual exempt amount)) x 10%), payable by 31 January 2025 (assuming distribution paid in 2023/24).

After reserving for this CGT cash available will be £364,103 (£410,970 - £10,000 - £36,867). A loan would therefore be required for the initial funding shortfall of £38,147 (£402,250 - £364,103). Any loan interest paid would be deductible in arriving at the gallery's profits. An additional loan facility would probably also be required for initial working capital purposes. It is noted that borrowing is something you wish to avoid if possible.

Introducing artwork to the gallery
Whilst this would be a disposal at MV no chargeable gains should arise. This is because no individual painting exceeds £6,000 in value so any gains will be covered by the small chattel`s exemption.

Operating as a sole trader
Trading Loss
A claim could be made for the loss of £100,000 for 2023/24 to be offset against your other income arising in the tax years 2020/21, 2021/22 and 2022/23, applying the loss to the earliest year first. The maximum loss offset will, however, be restricted to £50,000 each tax year. A saving of £25,892 would arise relating to loss claims for both 2020/21 and 2021/22 (2(years) x £12,946 (£5,892 (14730 (65000-37700-12570) x 40%) plus £7054 (50000-14730) x 20%). Because relief would only be obtained at 10% it would not be worthwhile partially relieving the chargeable gain for 2023/24.

Cash Basis
As receipts are forecast to be £60,000 for the first trading period an election to use the simpler cash basis of accounting (rather than accruals basis) is possible. This basis could continue providing annual receipts do not exceed £300,000. However, using this basis would mean that the trading loss would need to be carried forward to only use against future trading income and would not therefore be recommended.

Future position
Future profits would result in high marginal tax rates of 43.25%. If the business is eventually sold the base cost for chargeable assets (freehold property and goodwill) would be the price paid upon acquisition (£275,000 in aggregate) in June 2023. Any gains arising would, upon claiming BADR, likely attract a CGT rate of 10%

It is worth mentioning that an incorporation after the first loss-making period could be considered. This would enable the adoption of a more tax efficient remuneration strategy (see below) to avoid the high marginal tax rates of remaining a sole trader from year two onwards.

Purchase and operation as a sole trader - summary
Under the sole trader route the corporation tax charge of £64,030 arising on the sale of AAL's assets could not be avoided. Additionally, a personal CGT liability of £36,867 would arise upon the extraction of the required funds from AAL. A personal loan of at least £38,147 would also be required. Against this relief for the opening loss would result in aggregate tax refunds of £25,892.

Purchase and operation through AAL
General
If AAL is used to acquire the gallery, once established it will pay CT of 19% on taxable profits up to £50,000 and, effectively, 26.5% on any profits above £50,0000 and below £250,000, with a new Accounting Period beginning when the new trade begins. You will continue with the limited liability protection that a limited company provides, although any unidentified problems within AAL (eg historic tax liabilities) will also remain.

Introducing artwork to the business

Any chargeable gains arising upon introducing your personally owned paintings to AAL as stock would also be covered by the small chattels exemption. The £30,000 value of this could be left on loan account within AAL to enable tax free withdrawals as funds permit.

Trading Loss

The trading loss of £100,000 for the first period (ie calculated in the same way as before) could only be carried forward for use against the future profits made by AAL. Based on the forecasts the loss will fully relieve any chargeable profits for the AP to 31 March 2025 (obtaining relief of £13,475 (£50,000 x 19% plus £15,000 x 26.5%)) and partially relieve those for 31 March 2026 (obtaining relief of £9,275 (£35,000 x 26.5%).

It will not be possible to carry the loss back to relieve against profits (including the gains and balancing charge) for the AP ended 31 March 2023. This is because it is a condition for this loss relief that the same trade giving rise to the loss should be carried on in the previous period.

Rollover Relief (`ROR`)

Chargeable Gains

Since all of the proceeds are being reinvested into acquiring a further freehold property within three years, ROR could be claimed. It is worth noting that providing both properties have been or will be used in a trade carried on by AAL it does matter that the new trade is different from the old.

The effect would be that CT of £24,130 (£127,000 x 19%) could be saved. It is important to note, however, that ROR is only a deferral, and not a permanent, relief. The base cost of the new freehold property would be reduced by £127,000, meaning that when the new property is sold a larger gain will arise.

The gain on the lorry could not be relieved as lorries are not qualifying assets for ROR purposes.

Goodwill

A form of ROR is also available for intangible fixed assets such as goodwill. However, relief is restricted to the amount reinvested (£25,000) less the cost of the old asset (£25,000), so in this case no further relief is available.

Remuneration Strategy

You would only be subject to personal tax on any profits drawn from AAL (in the form of salary and/or dividends). A tax efficient strategy would be to draw a low salary (set at a level just above the primary Class 1 NIC threshold if you need to build up credits for state benefit purposes) and make use of your personal allowance and then top this up with dividends. Whilst the dividends would not be tax deductible for CT purposes, the first £2,000 (*reducing to £500 from 6 April 2024*) would be income tax free and they are NIC free. You mention that once the gallery is established you will not necessarily require the extraction of all available income to live on. If you are able to maintain your total future income at below the higher rate threshold (currently £50,270) the dividends would therefore be subject to an income tax rate of only 8.75%.

In this way income could be extracted from AAL whilst paying no tax on your salary, 8.75% on the dividends and 26.5% CT on AAL`s profits exceeding £50,000. This would compare favourably with the sole trader route. The advantage would, however, decrease if additional income is required. This will particularly be the case if all available income is extracted, especially once the higher administrative costs of trading through a limited company are taken into account.

The cash basis of accounting is not available for limited companies.

Future Position
Eventually the business could be sold either by selling your shares or AAL selling its T&A followed by the company being wound-up.

A share sale would be simpler, involving only one level of taxation. BADR would likely be available giving a CGT rate of 10%. However, your base cost for your AAL shares will be £260,000 less (£280,000 - £20,000) than under the sole trader route. This would cause a comparative increase in CGT liability of £26,000 (£260,000 x 10%).

A T&A sale would be more complex involving two levels of taxation (CT by the company on asset sales and personal CGT upon extraction of the proceeds to yourself). This would therefore compare even less favourably with the sole trader route.

Summary
Continuing to use AAL would mean that the acquisition funds would not need to be extracted from AAL, saving personal CGT of £36,867 as well as the liquidator's fees. Further there would be no need to take on any personal borrowings to buy the gallery. A claim for ROR would also mean that CT of £24,130 could be deferred (although not permanently saved). Additionally, the tax efficient remuneration strategy outlined above would compare favourably with marginal tax rates of 43.25% under the sole trader option.

However, relief for the initial trading loss would result in delayed and reduced savings of £3,142 (25,892 - £22,750 (£13,475 plus £9,275)) compared to the sole trader option. An eventual sale of the business will also result in at least an extra £26,000 tax liability. In the event that some profits are retained within AAL until an eventual sale, the increased share value would, upon a share sale, give rise to an additional 10% tax liability.

Setup Newco
As an alternative to using AAL, a new 'clean' company (ie one without any adverse history) could be used as a vehicle to acquire the gallery. The shares in Newco could either be held by AAL or yourself personally.

Newco as a subsidiary of AAL
AAL could subscribe for shares in Newco, providing funds to enable the purchase of the gallery. This would avoid the large personal tax charge that would accompany a personal extraction of these funds. After relieving the initial trading loss (by carrying them forward as outlined above) any future profits would be subject to CT as described above. Once Newco becomes profitable the tax efficient remuneration strategy outlined above could also be adopted.

Overall, however, this is simply a more complex way of structuring the gallery acquisition to obtain broadly the same benefits of simply continuing to use AAL. Indeed, there would be some disadvantages. Whilst AAL and Newco would form a 75% capital gains group, group ROR would not be available to relieve the gain on the disposal of the original freehold property. This is because this group would not have existed at the time of this disposal. Additionally, AAL would continue to exist so, because there are now two companies, administration costs would increase and more profits would be taxed at the higher rate of 26.5%. Setting up newco as a subsidiary of AAL is therefore not recommended.

Newco owned personally
Newco would need to be funded to acquire the gallery. Funds would therefore need to be extracted from AAL and passed to Newco to enable this.

As before the most efficient way to extract funds would be to liquidate AAL and make a capital distribution.

Because Newco will be a small unquoted trading company it should qualify for enterprise investment scheme ('EIS') purposes. If £400,000 is used to subscribe for new shares in Newco the majority of the capital distribution gain (and hence the CGT liability) could be relieved using EIS reinvestment relief ('RR'). No EIS income tax relief will be available, however, as you will hold more than 30% of Newco's issued shares.

Newco's first year trading loss would be carried forward and relieved and profits taxed and extracted as previously outlined.

Future Position and Summary
Under the Newco route no ROR would be possible so the full CT charge of £64,030 arising on AAL's trade and asset sale could not be avoided. Using a capital distribution would mean that liquidation fees would also be incurred. Relief for the initial trading loss would again result in delayed and reduced savings of £3,142 compared to the sole trader option.

Owning Newco personally and claiming RR would, however, substantially relieve the 'upfront' personal CGT liability of £36,867 and avoid the need for any borrowings. Further a base cost of £400,000 for your shares in Newco compares favourably with both the sole trader option (£275,000) and continuing with AAL (£20,000) potentially leading to comparative savings, upon a share sale, of £12,500 (£125,000 x 10%) and £38,000 (£380,000 x 10%) respectively.

It is important to note, however, that RR is not a permanent relief. The relieved gain will return to charge (at a CGT rate of 10% as BADR should be available) if a chargeable event occurs, which includes a sale of Newco's shares. This would therefore significantly erode any base cost benefits obtained.

Appendix I

Chargeable asset Disposals

	£
Intangible asset	
Goodwill	
Trading profit	100,000

The purchased goodwill was acquired between 1/4/2002 and 8/7/2015 so relief would have been fully obtained for the amortisation totalling £25,000 over the ten-year period to 31 March 2018. The residual tax written down value would therefore be nil.

Chargeable gains

Freehold property

		£
Proceeds		250,000
Less:	Cost	(100,000)
	Indexation: 100,000 x 0.230 (278.1-214/214)	(23,000)
		127,000

Lorry

	£
Proceeds	40,000
Less: cost	(30,000)
	10,000

Remaining equipment exempt.

Final capital allowances adjustment

	£
Tax written down value b/f	Nil
Disposal proceeds:	
Equipment	50,000
Vans	20,000
Lorry (restricted to cost)	30,000
Balancing charge	100,000

Appendix II

Funds required	£
Business purchase	310,000
SDLT on property (250,000 – 150,000 x 2%) + (5,000 * 5%)	2,250
Preliminary expenditure	90,000
	402,250
Funds available	
Trading assets sold	485,000
Debtors realised	35,000
Bank	30,000
Creditors paid / payable	(75,000)
	475,000
Less CT on chargeable asset disposals 337,000 x 19%	(64,030)
	410,970

Appendix III

Trading Loss for Period ended 31/3/2024

	£
Per forecast	9,840
Pre-trading expenditure	
Marketing	9,000
Decorating	3,000
Capital allowances (W1)	77,300
SBA (W2)	860
Trading loss	100,000

W1 - Capital Allowances

	£	
Assets purchased:		
Equipment	5,000	
Fixtures	37,300	(per s198 election)
Preliminary expenditure		
Display units	10,000	
Other equipment	10,000	
Other	15,000	
Eligible for AIA	77,300	

W2 - Structures & Buildings allowance

43,000 (58,000 – 15,000) x 3% x 8/12 = £860