The Chartered Institute of Taxation

Application and Professional Skills

Taxation of Owner-Managed Businesses

November 2021

Suggested solution

Ms Phoebe Tanner
Hack Marketing Ltd
West Lane
Big Town
BL 9 5LL

Paul Links
AC Accounts LLP
Hove House
Big Town
BL5 1PS

12 November 2021

Dear Phoebe

Possible sale of Hack Marketing Ltd

Further to your email of 30 October I have set out below the tax implications of the proposed sale of Hack Marketing Ltd.

Introduction

The objective of this letter is to advise the shareholders of the company on the most tax efficient structure for the sale.

In addition I will advise on the most appropriate mechanism for the extraction of Le Mabelle prior to the sale of the company.

Terms and limitations

My advice is limited to UK taxation and any overseas tax issues should be addressed to a suitable qualified specialist. My recommendations are based on current legislation and in the event of any delay then this advice should be updated to reflect any changes.

My responsibility is to the directors of Hack Marketing Ltd and the advice set out below should not be relied upon by other parties.

Key issues

This letter considers a range of tax issues in arriving at the recommendations set out in the Conclusion and Recommendations section. I have addressed these under the following headings:

1) Sale of company shares

I have started this analysis with a consideration of the tax implications of a sale of company shares as this is the most straightforward option and is likely to be the most tax efficient.

The sale of shares will be a capital gains tax (`CGT`) disposal by the individual shareholders. The amount of the gain will be the difference between their share of the sale proceeds and the individual base costs of their shares. Any CGT will be payable 31 January after the end of the tax year of the disposal.

I have set out below the principal tax considerations for each of the shareholders:

a) Mary Hack

The tax base cost of Mary's shares will be made up of two elements: Firstly the shares she was gifted by your father in June 2004. As this was an inter-spouse transfer she will have taken on your father's historic base cost which will have been the subscription price of £1 per share.

The balance of the shares she received from your father's estate will have a base cost equivalent to their market value at the date of his death. As the shares passed directly to your mother there was no requirement to agree a value for probate at that time. It will now be necessary to undertake a valuation exercise and this will be subject to agreement with HMRC.

The taxable gain will be the difference between the sale proceeds and the above tax base cost. Mary will be able to deduct her capital gains annual exempt amount of £12,300 and the balance will be taxable. The first £1m of her gain will benefit from business asset disposal relief (BADR) (see Appendix 1) and will be taxed at 10%. Any excess will be taxed at 20%.

Market International Ltd have indicated that they would also wish to acquire Hack House from your mother. This would be a personal disposal by your mother and I have summarised the tax considerations in Appendix 2.

b) Phoebe Tanner

When the shares were gifted to you in 2004 you entered into a joint gift relief election with your father. The consequence of that election is that you are treated as taking on his historic base cost of the shares being £1 per share.

I would anticipate that you will qualify for BADR on your share of the gain and therefore you will pay CGT at 10% on the excess over your annual exempt amount.

c) Phil Hack

Where an individual is not resident in the UK for a minimum of five years certain chargeable gains arising whilst they are overseas will not be taxable in the UK, including shares in a UK company. Therefore, provided Phil remains non-resident until 11 October 2022 he will have no UK tax liability on the sale of his shares. If he does return to the UK before that date he must disclose the gain and it will be taxable in the year of return. As he is not an employee or director he would not qualify for BADR so would pay 20% tax on any gain which arises.

Phil should seek advice in Australia on any tax implications in that country.

d) Dean Marks

I have assumed that Dean will elect to exercise his options immediately prior to any sale.

It is necessary to consider the tax implications for both Dean and the company on the exercise of his enterprise management incentive (`EMI`) share options as well as any subsequent disposal of the underlying shares.

The exercise of the options will result in an income tax charge for Dean based on the difference between the exercise price (£1 per share) and the market value (£625 per share) at the date of grant. On 35 shares this will result in taxable benefit of £21,840.

As he will be exercising his options in anticipation of a sale of the company's shares this will make the shares "readily convertible assets". As such the benefit must be treated as additional earnings and must be processed through the company's payroll in the month of exercise. If Dean's salary is insufficient to cover the additional NIC and PAYE then he must ensure that the company is reimbursed for the shortfall.

It is important that both Dean and the company enter into a joint election, known as a "section 431 election" no later than 14 days after the exercise of his options. This will ensure that any gain on the subsequent sale of the shares will be subject to capital gains tax and not income tax.

The tax base cost of the shares for Dean will be £625 per share. His share of the sale consideration in excess of this value and his annual exempt amount will be taxed as a chargeable gain. If the sale takes place after 7 January 2022 then he will have held the options for at least two years and he will benefit from BADR (see appendix 1). In this case the gain will be taxed at 10%. If the sale takes place before 7 January then he will not have held the options for the minimum qualifying two year period. He would therefore not qualify for BADR and the gain will be taxed at 20%.

Company tax implications

The exercise of Dean's share options also has important company tax implications. The company will be able to claim a corporation tax deduction equivalent to the difference between the market value of the shares on the date of exercise and the subscription price of £1 per share. This will be shown as a tax deduction in the company's corporation tax computation in the year of sale.

The exercise of the options must be disclosed by the company on its annual EMI return before the 6 July following the end of the tax year of exercise.

2) Sale of trade and assets

If a sale of shares is not possible then the alternative will be a disposal of trade and assets by the company. The principal concern in the event of a sale of trade and assets is that this is likely to result in two layers of taxation. Firstly within the company and secondly on the individual shareholders when the funds are withdrawn. I have dealt with these in turn below:

a) Company tax implications

The company will sell the individual assets set out in the letter of offer from Market International Ltd. The tax treatment will be as follows for each of the elements sold:

i) Goodwill

There is no base cost for the company's goodwill. As such the sale of this asset will crystallise a fully taxable capital gain of £1,200,000.

ii) 11-13 Rose Road

This will be a capital gain in the company. In calculating the taxable gain the acquisition cost of £325,000 will be reduced by the gain of £85,000 that was rolled over on the disposal of the previous premises. The adjusted base cost will be increased by indexation relief. This is the purely inflationary Retail Price Index increase in the value of the property from the date of purchase up to December 2017 when the relief was frozen.

iii) Stock

The sale of stock will be a simple trading receipt.

iv) Plant and Machinery

The sale proceeds will be shown as a disposal in the company's capital allowances calculation. As the sale proceeds will exceed the tax written down value brought forward then this will result in a balancing charge which will be taxed as additional profit.

The capital gains and trading profits arising on the sale of the above assets will be subject to corporation tax at 19%.

The sale would be treated as a cessation of trade. This is deemed to be the end of an accounting period. As such any tax due will be payable nine months after the sale.

3) Extraction of funds from Hack Marketing Ltd

You have indicated that the shareholders wish to receive funds personally and therefore you will need to extract the post-tax proceeds from the company. This could be achieved by way of a dividend but this would result in a substantial personal income tax liability for all of the UK resident shareholders: To the extent their total income, including this dividend, exceeded £150,000 then the effective tax rate would be 38.1%.

As an alternative to voting a large dividend the directors should consider a formal liquidation of the company.

A liquidator would be appointed following the sale of the trade and assets. The liquidator's responsibility is to collect the company's debts and meet any liabilities. The net funds and assets would then be distributed to the shareholders in proportion to their respective share holdings.

Each distribution of funds by the liquidator (assuming there is more than one) would be treated as a part disposal of the shareholder's shares. The CGT consequences for the shareholders are almost identical to a share sale as outlined in Section 1 above although on two distributions falling into two different tax years two amounts of annual exempt amounts (£12,300) would be available to each shareholder. The only differences are outlined below:

BADR on liquidation

The shareholder will continue to qualify for BADR on the gains arising on the distributions from the liquidator subject to the following conditions:

a) They must meet the qualifying criteria set out in Appendix 1 at the date the company ceases to trade.
b) The distributions by the liquidator must be made within three years of cessation of trade.
c) They must not fall foul of the targeted anti-avoidance provisions noted below.

Targeted Anti Avoidance

I note that you and Dean intend to remain in business in the field of marketing. It is therefore important that you are aware of targeted anti-avoidance provisions introduced in 2016. These were introduced as a means to ensure that taxpayers did not use a company liquidation to artificially realise a capital gain. Where the provisions apply then the receipts from the liquidation will be taxed as dividends rather than capital gains.

The anti-avoidance will only apply where all four of the following conditions are met:

a) The individual must hold at least 5% of the share capital.
b) The company must be a closely held family company (which is the case here).
c) Within 2 years of the liquidation the individual shareholder must carry on a trade or activity which is the same or very similar to that being undertaken by the liquidated company.
d) It is reasonable to assume that one of the main purposes of the liquidation is to achieve a reduction in tax.

As you and Dean intend to continue in the marketing sector it is necessary to consider the above provisions.

Firstly Dean would not satisfy the 5% shareholding test and therefore he is automatically excluded.

You will meet all of the first three tests. As such it will be necessary to rely on failing test "d" in order to avoid being taxed under these provisions. I believe that you have a strong case that the anti-avoidance should not apply and I have set out several key reasons below:

Firstly, your mother is the principal and controlling shareholder and will ultimately dictate whether the sale takes place.

Secondly, the sale of trade and assets rather than a share sale may be dictated by Market International Limited.

Finally, in the event the trade and assets were to be sold then there will be compelling commercial reasons to liquidate the company.

In light of the above I do not believe that HMRC would be in a position to argue that the liquidation is being undertaken for the purposes of tax mitigation. As such I do not believe that the anti-avoidance provisions would be applicable.

EMI share options

If Dean exercises his share options immediately prior to the company's sale of its trade and assets then we would contend that there was no formal arrangements in place to dispose of his shares at that point. As such they will not be treated as readily convertible assets. This means that the income tax charge arising on the exercise of the options will not be subject to PAYE and NIC in the month of exercise. Instead the benefit must be disclosed on Dean's self assessment tax return and any tax will be payable on 31 January following the end of the tax year of exercise.

4) Extraction of Le Mabelle

It is evident from the above that the double layer of taxation associated with a trade and asset sale means that a simple share sale would be much more tax efficient. Market International Ltd have indicated that they will not consider a purchase of shares whilst the company owns the ski chalet. As you wish to retain the property it will have to be extracted from the company prior to a sale of shares. This can be achieved in one of two ways:

Firstly you could simply purchase the property from the company. Regardless of the amount actually paid this will be treated as if it is a disposal by the company at current market value. This will crystallise a capital disposal in the company and the resultant gain will be subject to corporation tax at 19%. The gain will be the difference between the current market value and the original purchase cost enhanced by indexation relief.

If you pay less than full open market value then you would be subject to income tax on any shortfall. As you are both a shareholder and an employee then depending on how this was structured the shortfall could be taxed as either a dividend or a taxable benefit.

Obviously a sale at anything less than current market value would reduce the value of the company for the other shareholders and as such it is unlikely that this would be acceptable. I would therefore recommend that you consider purchasing the property at full value from the company. If you do choose to do this then you will need to take local Swiss advice to establish whether there are any local taxes to pay.

5) Conclusions and recommendations

As you can see from the above, a sale of trade and assets will result in two distinct layers of taxation. Firstly any gains and profits on the disposal of assets will be subject to 19% corporation tax in the company. Secondly the individual shareholders will be subject to either income tax or capital gains tax on the extraction of the sale proceeds from the company. If this is undertaken through a company liquidation then you and Dean will have to be careful that you are not caught by the targeted anti-avoidance provisions which would treat the gain as income.

In contrast to this, a direct sale of shares removes this risk and will offer significant tax advantages because it will avoid any tax liability within the company. The UK resident shareholders will be subject to capital gains tax at either 10% or 20% depending on their entitlement to BADR. Phil, as a non-resident, will have no UK tax liability whatsoever (but may have a liability in Australia and should take advice on this).

In light of the above considerations I believe that a personal sale of shares rather than a company sale of trade and assets would be the most tax efficient route to follow.

In order to secure a share sale you will need to extract the ski chalet from the company prior to the sale of your shares. The most straightforward route would be a sale of the property to a third party. This is not attractive as you have indicated that you would like to retain ownership yourself. A sale to you at anything less than full market value would result in a personal income tax liability and adversely impact the other shareholders. As such my recommendation is that you purchase the property from the company at its current market value. Subject to the agreement of Market International Ltd, the funding for this purchase could be linked to the sale of the company. This would avoid the need for you to raise independent finance for the purchase.

I hope that the above is clear and if you have any questions please give me a call.

Yours sincerely

Paul Links

AC Accounts LLP

APPENDIX 1

Business Asset Disposal Relief (BADR)

The standard capital gains tax rate on a sale of shares and commercial property is 20%. BADR reduces this rate to 10% for qualifying capital gains. Each individual has a maximum lifetime BADR allowance of £1 million.

Shareholders will benefit from BADR provided they meet the following qualifying conditions for at least two years prior to a disposal of their shares:

They must be employees or directors of the company and be entitled to at least 5% of:

- The ordinary share capital
- Voting rights
- Assets on a winding up or proceeds on a sale

In the case of shares acquired through EMI share options the 5% holding tests do not apply. The two year qualifying period still applies but this is deemed to commence at the date of grant of the EMI options.

"Associated disposals"

BADR may also apply to gains arising on the sale of personally held business assets, typically commercial property. The property must have been owned for at least three years and be used by the owner's company for their business. The disposal of the property must be in association with the disposal by the owner of at least 5% of the share capital of the company.

The proportion of any gain that qualifies for BADR may be restricted on a time apportionment basis where there is a period where the property has not been used for business purposes by the company. Further restrictions apply where the property has been used by the company but rent has been charged. A full commercial rent charge will prevent entitlement to BADR. If less than a commercial rent is charged then the restriction is pro-rated.

APPENDIX 2

Sale of Hack House

The sale of Hack House will be a personal capital gain by Mrs M Hack.

The tax base cost will be the original acquisition cost together with any costs of purchase. As this is an individual disposal there is no uplift through indexation relief.

As the property sale will take place in connection with the disposal of Mrs Hack's shares then part of the gain may potentially benefit from BADR as an "associated disposal" (see Appendix 1). This assumes that she will not have fully utilised her lifetime allowance of £1m on the sale of shares.

The element of the gain that may benefit from BADR is restricted on a time apportionment basis where the property has not been used by Hack Marketing Ltd on a rent free basis. If we assume that Hack House is sold in say December 2021 then the total period of ownership will be 20 years. From April 2001 to April 2012 it was let to third parties and no relief is available for this period. As such 9/20th of the gain will be potentially eligible for BADR and taxed at 10%. Any element of the gain not covered by BADR will be taxed at 20%.