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Application and Professional Skills

Owner-Managed Businesses

Suggested solution

REPORT TO PETER WALNUT AND PHIL PEANUT IN RESPECT OF PROPOSED PROPERTY MAINTENANCE BUSINESS

Introduction

As requested in the letter from Peter Walnut of 29 October, this report considers matters relating to the proposal to set up a property maintenance business with Phil Peanut. There are two key elements which have been considered:

- 1) How best to structure the business including a consideration of the extraction of profits and the involvement of wives and children
- 2) The relationship between the new business and the workers

Executive Summary

Structure of new business

The participants wish the new business venture to be a separate structure from the existing business entities. A limited liability structure is appropriate given the identified risks and it is recommended that a newly formed limited company should be used. This gives greater potential for reduced tax and National Insurance liabilities, and gives an entity in which it is simpler to transfer an interest to your children.

The split of ownership of the shares can be agreed after discussions based on financial, work and time input. It would be possible for shares to be held by wives and children. This would give the opportunity to mitigate the tax liabilities on the extraction of profits. It would be recommended that the wives are given shares if the business is profitable as there is availability of basic rate band for both wives which could mitigate the tax liability on profits extracted. If this is done later, this would be tax-free.

If shares are not given to the wider family at the outset they can be transferred later with holdover relief being claimed in relation to any gain arising on a transfer to the children, subject to the meeting of the relevant conditions.

Alternatively they could be employed and remunerated for work that they do.

Profits could be extracted as salary, dividends or pension contributions with dividends likely to be the most effective option for direct extraction of profits for tax purposes.

Relationship with the workers

The employment status of the workers is dependent upon a number of factors detailed in this report.

The specialist workers are most likely to be treated as being self-employed based on the information provided.

We would consider that the general workers would be employees. You will need to register as an employer and meet compliance obligations but the cost will be greater. Legal advice should also be taken on employment law issues.

1. Business Structure

The first thing to consider is how the proposed joint venture between Peter and Phil should be structured to give the most tax efficient and commercially effective outcome. There are various different structures which could be considered, both corporate and unincorporated, and these are outlined below. Each of these has their own advantages and disadvantages, and some are not appropriate due to the requirements of the new business. For example, we have not considered further any structure involving either you or Phil becoming part of the other's existing business or one of the existing businesses contracting with Nutville Properties Limited (NPL) given your aim to keep the new business separate.

Possible structures include:

1. A new unincorporated partnership with both as partners
2. A limited liability partnership again with both as partners
3. A newly incorporated company specifically for this purpose.

The issues which need to be considered in determining how the new business is structured are detailed below.

Risks arising

The new venture will be responsible for dealing with any defective works and negligence claims from NPL and/or the tenants. Whilst insurance can be obtained (and public and employers' liability will be required in any case), it is nevertheless advisable to take advantage of the additional protection that a limited liability entity may provide.

Loans

The initial set-up funding could be made via loans or external funding regardless of the structure utilised so this does not impact on the decision.

Asset purchases

If the business purchases the vans and equipment that are needed they will qualify for capital allowances including the Annual Investment Allowance (AIA), which provides 100% tax relief in the year of purchase. Again, this applies regardless of the business structure so does not impact on the decision. There are restrictions on the AIA available where there are linked businesses but the current level of expenditure for all business would mean it is unlikely that this would have an impact.

Losses

If a new limited company is used any losses made would only be available to carry forward against its own future profits. If an unincorporated entity is used the losses would be personal losses allocated between the individuals. In such circumstances the losses could be offset against any other personal income, which may be of short term benefit and an unincorporated entity might be better initially until profits are generated. We assume however that losses are not anticipated.

VAT issues

The work carried out by your new entity will be standard rated if your business is VAT registered. The majority of the properties owned by NPL are residential in which case the rent they charge to the tenants will be exempt from VAT. As a result any VAT charged on the maintenance costs by the new entity will be irrecoverable by NPL. The position is the same for the commercial properties unless NPL have made an option to tax the relevant properties.

As a new business entity there is potentially a short term benefit until such time as the VAT registration limit is exceeded which would apply regardless of the structure used. There is possibility that HMRC could link the two businesses but this risk is low if the two businesses are distinct, which it would appear is the case here.

Transferability

If a corporate type structure is used it is simpler to transfer shares to other family members by way of simple share transfers. The transfer of an interest in a partnership to other family members may not be as straightforward as there is greater consideration needed of the as to profit shares and underlying ownership of assets.

Tax and National Insurance Liabilities

Carrying out the business via a separate limited company will give greater flexibility to minimise tax and National Insurance liabilities by extraction of profits as dividends rather than salary with only minimal extra accounting costs. Appendix 1 gives a breakdown of the comparative tax payable under the two options. On the basis of profits of £30,000 and all profits being extracted as dividends, there is a tax saving of £242 by using a company. This would increase if the profits were higher such that they would push Peter and Phil into higher rates of tax. If there were other shareholders, or not all profits were extracted, the tax savings would increase.

Best structure given scenario

The options which would seem to be appropriate in this scenario would be to use either a limited liability partnership or a limited company due to the advantages of limited liability

We would recommend that the new venture is carried out by way of a newly incorporated company with the shares initially held by Peter and Phil.

In addition to giving protection for possible claims, this gives an entity in which it is simpler to transfer an interest to your children and gives greater potential for reduced tax and national insurance liabilities. The only real downsides are in relation to the more restricted use of any potential losses. There would also be slightly higher accounting costs but this would be unlikely to significant.

It would be possible for Phil to transfer his business into any new company in the future if this became an appropriate option, as he is currently uncertain about his long term aims.

You will need to discuss the ownership of the company in terms of percentage interests, input and profit shares.

There is complete flexibility in setting up the company as you can hold the shares in whichever proportion would seem to be appropriate between you both or have some shares held by family members.

2. Tax, National Insurance and other financial issues for the new business

On the basis that the new business is carried on by a newly incorporated company we need to consider the tax implications for both the company and the individuals and how such liabilities can be minimised.

a. Corporation Tax

Any profits made by the company will be liable to corporation tax at the rate applicable for that accounting period. Any corporation tax will become payable 9 months and 1 day after the end of the accounting period. If losses arise they can, as noted above, only be carried forward against future profits chargeable to corporation tax in later accounting periods.

b. Assets acquired

Any assets such as vans and equipment that the company acquires will potentially qualify for capital allowances at 100% of the cost (excluding VAT if VAT registered) under the Annual Investment Allowance (AIA) rules. Given the current level of AIA, it is likely that all expenditure would be covered by this relief. We note that you are envisaging that two small vans are needed and rather than purchase you could use the existing vans, one owned by Walnut Electrics Limited (WEL) and one by Phil's sole trade business. However, this might cause issues in terms of reimbursing the costs and it might be more straightforward to acquire new vehicles, particularly since there is tax relief available.

c. Funding

The set-up costs are expected to be in the region of £20,000 and it will need to be decided as to how this will be apportioned between Peter and Phil and also how it should be introduced into the new company. The simplest route would be to loan the money to the company with the loan being repaid over an agreed period. I note that WEL had cash at bank of £22,500 at the last accounting date at 30 June 2019. Also, Peter is owed £20,000. Potentially therefore these monies could be used to fund all or part of the set up. We do not have details of any personal monies held by Phil although he could of course consider taking out additional bank loans. If either of Peter or Phil do make loans to the company, they could charge a commercial interest rate. When interest is paid, basic rate tax will need to be deducted at source by the company which can then be offset against the tax on the individual. Once the company has sufficient funds it can repay any such loans.

In the event that the company fails, and the loan becomes irrecoverable a capital loss will arise for the individual available for offset against gains in the year or future capital gains assuming that HMRC do not argue that the lender has contributed to the loan becoming irrecoverable.

The alternative means of funding the set-up costs would be by investing the monies in share capital but this would lock the money into shares and could create discrepancies when looking at the respective shareholdings of Peter and Phil. The only benefit would be that any capital loss arising on a future disposal of the shares could be set against income if the relevant conditions are met.

The company could attempt to borrow the money from a bank but as a start-up but this may prove difficult and in any event personal guarantees would most likely be required.

d. Use of WEL property

As the property owned by WEL is to be used for storage and as the administrative centre a rent charge should be considered separately from any decisions about how the profits are to be shared. The rental charge would be deductible against income in the new company and liable to corporation tax in WEL. We would need to consider this point further as this would be an investment activity for WEL which might prejudice the trading company status of the company for the purposes of capital tax reliefs such as entrepreneurs' relief.

e. Other taxes

On the assumption that the company is a trading company which it would be based on the known potential activities, the shareholdings will qualify for Business Property Relief and be exempt from Inheritance Tax after a qualifying two-year period. Additionally, as a trading company the shares could be sold subject to certain qualifying conditions with the benefit of entrepreneurs' relief at a 10% CGT rate.

3. Extraction of profits

a. Salaries

The company could pay salaries to Peter, Phil or their children if they are, or become involved in the business. Salaries should be commensurate with the work done. The salaries would be deductible for corporation tax purposes. Normally salary would be at just below the National Insurance (NI) threshold to preserve entitlement to statutory benefits such as state pension but both Peter and Phil, and their wives have income above the NI threshold already so this is not necessary. It may be more tax effective to pay dividends.

b. Pension contributions

The company could additionally consider making employer pension contributions as a tax efficient and NI free way of extracting profits for any of the individuals concerned. Such contributions would be deductible for corporation tax purposes as long as they are wholly and exclusively for the purposes of the trade. We have no details of pension contributions having been made and it would be good planning to look at this issue.

c. Shareholdings/Dividends

Although it is possible to pay salary to the individuals involved in the company, it may be more tax effective to pay dividends to the shareholders, on the assumption that the company will have sufficient distributable reserves to do so.

If there is a need to pay different levels of dividends to Peter and Phil (or to the wider family if they become shareholders) then it would be possible to have different classes of shares to enable this to be done although care needs to be taken to ensure that the rights attached to those shares do not mean loss of other reliefs. This point can be discussed further in due course.

4. Shares held by Children/two families

Peter and Phil could decide that some of their respective shareholdings be held by their wives and children. This could be from the start or alternatively could wait to see if the business succeeds and transfer shares at a later date. If the wives and children were given shares from the outset they will simply be issued at nominal value. If transferred later when the company has value, the position would be different for the wives and the children.

a. Shares held by wives

We would recommend that a proportion of the shares are transferred/held in your wives names to make the best use of their dividend allowance and the lower dividend rate of tax (7.5%) in the basic rate band as both wives have unused basic rate band with Peter's wife Wendy also having unused personal allowance.

If shares were not initially held by the wives but subsequently transferred, no capital gains tax charge would arise. Transfers between spouses take place so that no gain or loss arises on the transfer so there are no tax issues arising.

b. Shares held by children

As noted above, the children could be employed by the company and paid remuneration commensurate with the duties they perform. However, it has been indicated that it might be appropriate for them to hold shares.

Two of the children have income just above the personal allowance with the other no income as at university which again would allow payment of dividends to get income into the hands of the children. However, it may be better to consider this once the business is established.

If transfers to the children were made to the children once the company had value, this would be deemed to take place at market value as the children are connected parties but 'hold-over' elections could be made to avoid a charge to capital gains tax arising assuming the relevant conditions are met

It may be worthwhile therefore waiting for two years before transferring shares to children as the transfer would be a potentially exempt transfer but could be covered by business property relief if the transferor dies within 7 years and the shares qualified at the point of transfer.

Normally if someone is an employee and they receive shares, they will be subject to tax on the market value of those shares under the employment related securities provisions. However there is an exemption where shares are transferred from an individual due to a family relationship so there would be no risk of an income tax charge on a transfer to the children in later years, even if they had been previously employed.

c. General issues

If shares are to be transferred into the names of children care will be required as they will from that point be the beneficial owners of the shares with the same rights as any other shareholder. We should therefore consider having a shareholders agreement prepared to deal with all shareholder issues/eventualities. A shareholders agreement would be strongly recommended in any event as two different families are involved. What would happen for example if Phil wanted to cease involvement but Peter wanted to continue? A shareholders agreement could deal with this and similar issues.

5. Contract Terms with subcontractors

There is no definition of what determines employment or self-employment so you need to review various factors to understand what the potential status would be. You cannot decide to treat workers as self-employed if they are employees.

Looking at the two types of worker that it is envisaged will be utilised by the new business there is a clear distinction.

The general labourers are likely to be considered to employees because:

- They will have to agree to be available for call-out and the new business will have to have staff to man the call-out rota; plus they would have to give this business priority
- They would be provided with all tools and materials
- Your business would have control over what work is done and how it is done
- They would be paid for hours worked

We believe that these workers would be categorised as employees and so there is a significant risk to the business to treat them otherwise. You would need to register as an employer and meet the relevance compliance obligations relating to these individuals as employees. There will be additional costs due to liability to Employers' National Insurance Contributions. They will also be entitled to holiday pay, sick pay, to be paid national minimum wage and be auto-enrolled into a pension scheme. Your costs will therefore increase and you need to factor this into the costings of the work to be done.

However, the specialists are likely to be self-employed because:

- They are paid on a fixed fee basis and have to rectify work at their own cost so there is financial risk
- The worker will provide the tools to do the work
- The worker will determine how the work should be done so they are not under the control of the business
- They have other customers and do not have to work for the business

On the basis of the above, it is not considered that there is significant risk to the business for those individuals to be paid on a self-employed basis. It is important to ensure that there is no material change in the terms and conditions under which these individuals work as the business develops. The only additional costs will be VAT if they are VAT registered.

Working 1

Peter	Current position		New position	
Salary	£8,000		£8,000	
Profit			15000	
Dividends		22,500		22,500
Less PA	<u>(8,000)</u>	<u>(3,850)</u>	<u>(11,850)</u>	<u> </u>
Taxable	-	<u>18,650</u>	<u>11,150</u>	<u>22,500</u>

Tax

11,150 x 20%		2,230
2,000 x 0%	-	-
16,650 x 7.5%	1249	
20,500 x 7.5%	<u> </u>	<u>1,538</u>
Total tax	<u>1,249</u>	<u>3,768</u>

Increase = £2,519

ASSESSMENT NARRATIVE

Structure

A simple pass or fail will be awarded.

Identification and Application

The following are the relevant topics for assessment with their weightings:

1	30%	Structure of new venture including discussion of options based on facts presented, pros and cons of each from a commercial and tax perspective
2	20%	Review of the tax implications including CT, treatment of assets purchased, potential funding issues and use of existing property
3	20%	Profit extraction issues for different individuals considering other income and the use of salaries, pension contributions and dividends
4	10%	Potential for shares to be held by spouses and children, whether to transfer now or in the future and the tax treatment of each
5	20%	The status of each group of workers and how the company should treat each

A grade of 0,1,2,3, or 4 is awarded for each topic. The weighting is applied to that grade to produce a weighted average grade. Thus, supposing a candidate scores 3, 3, 4, 2 and 2 respectively on the above topics, this will equate to weighted scores of 0.9, 0.6, 0.8, 0.2 and 0.4. The total of these scores is 2.9. This is then converted to a final absolute grade by rounding up or down to the nearest grade. Thus, scores in the range 2.5 to 3.49 will be a grade 3. In this example, the candidate will score a grade 3 overall and secure a pass for this skill.

Relevant Advice and Substantiated Recommendations

The following are the topics for assessment with their weightings:

30%	Advice and recommendation on the most appropriate business structure to use for the new venture
25%	Advice on the potential employment status of the two groups of individual workers and recommendation of how the company should treat them
30%	Advice and recommendation on the most tax effective way to extract profit
15%	Advice and recommendation on bringing spouses and children into the business

The final grade will be determined for this skill in the same way as for Identification and Application.