The Chartered Institute of Taxation

Application and Professional Skills

Taxation of Owner-Managed Businesses

May 2024

Suggested answer

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Date : 2 May 2024

Sale of Charlotte Ceramics Ltd

Introduction

As agreed, this report considers how the sale of Charlotte Ceramics Ltd (`CCL`) to Superior Ceramics Ltd (`SCL`) could be structured. Our analysis is based on the information provided by yourself, particularly that relating to asset values and on the assumptions that these values will not materially alter in the period to sale, and that the sale will occur on 30 June 2024. As agreed this report does not consider any inheritance tax implications.

Executive Summary

A direct sale of your shareholding in CCL to SCL would achieve the greatest after tax proceeds, for yourself, estimated to be approximately £941,000.

A sale of assets by CCL to SCL followed by a recommended formal liquidation of CCL would ultimately only realise estimated after tax proceeds of around £846,000.

This might be improved to up to around £870,000 with a negligible value claim for CCL`s shareholding in Crowley Glass Ltd and negotiating a reduction in the proceeds to be used for capital allowances purposes for the property fixtures.

To maximise after tax proceeds it might be possible to encourage SCL to directly buy your CCL shares through the use of appropriate warranties and indemnities; a reduction in the sale price; and/or transferring the selected assets to Charlotte Retail Ltd (`CRL`) and using this company as the sale vehicle.

As a compromise the use of CRL might particularly appeal to SCL. They could acquire the assets they want via a `clean` company whilst also obtaining a valuable uplift in base costs for any chargeable assets.

Sale of Trade and Assets

Cessation of Trade

SCL is proposing to buy the trade and selected assets from CCL. This will result in a cessation of CCL's trade. If the sale occurs before 30 June 2024 this would bring an end to the accounting period (`AP`), thus accelerating the due date for any corporation tax (`CT`) payable for this shortened period.

Because the trade has ceased capital allowances balancing adjustments will also be made. It is not possible to claim any capital allowances for this final period. As shown in Appendix I, a trade and asset (`T&A`) sale will therefore result in a maximum balancing charge of £169,500.

Chargeable Assets

The disposal of any chargeable assets will give rise to chargeable gains or allowable capital losses. As shown in Appendix I chargeable gains of £180,687 and £96,600 (i.e. £277,287 in total) will respectively arise in relation to the disposal of CCL's goodwill and factory. The sale of the latter will result in the effective clawback of structures and buildings allowances previously claimed amounting to £21,600, which are treated as additional sales proceeds. The capital loss brought forward of £25,000 can be offset against these gains, giving a final figure of £257,287. There is no taxable gain on the office and warehouse as the allowance for inflation reduces it to nil.

Because no item of equipment will be bought or sold for more than £6,000 any gains arising on their disposal will be exempt under the small chattel`s exemption.

If the sale occurs on 30 June 2024 the CT arising for the year ended 30 June 2024 becomes £117,947 (Appendix I), payable by 1 April 2025. The original forecast CT liability was £9,500 (£50,0000 x 19%), so the maximum extra CT attributable to the sale will be £108,447 (£117,947 - £9,500).

Double Tax Charge

As detailed above, with a T&A sale, a CT charge will arise. Following the sale, the intention is for CCL to be closed down. This will mean that any residual funds will need to be extracted from the company and paid to yourself. This will result in a further tax charge arising. As a consequence, this will inevitably lead to a double tax charge occurring, which is one of the principal disadvantages of this sale route.

Extraction of Funds

Before closing CCL

The funds could be extracted by taking additional salary and/or dividends.

Additional salary would expose you to very high marginal income tax rates (with most payable at 45%) and also lead to the loss of your personal allowance. This would also be subject to both employee`s (mostly at the rate of 2%, although some (between existing salary of £25,000 and the upper earnings limit of £50,270) at 12%) and employer`s (at 13.8%) Class 1 national insurance contributions (`C1NIC`). Whilst the salary payment and employer's NICs would be tax deductible for CT purposes from a tax perspective the net result would be expensive and therefore not recommended. It is perhaps also worth noting that, to obtain a CT deduction, the salary payment would need to be accrued within CCL`s final period of trading and paid within nine months from the end of that period.

Because dividends are not subject to NIC, an additional dividend payment would result in a lower overall tax charge. However, you would still be exposed to high marginal income tax rates, with most payable at 39.35%, and dividends are not deductible for CT purposes. This method is therefore also not recommended.

After Closing CCL

The closure of CCL could be achieved either (i) by applying to Companies House for the company to be `struck off`, or (ii) by passing a resolution to appoint a liquidator to collect/pay any residual debtors/creditors and formally dissolve the company. Both methods will result in the cancellation (i.e. effective disposal) of your shareholding in CCL.

Dividends paid following a striking off application may be treated as a capital distribution (and therefore subject to capital gains tax (`CGT`)), providing they do not exceed a specified cap of £25,000. As shown in Appendix II residual funds of CCL will greatly exceed this amount. As a result, the payment would be treated as a `normal` income dividend and taxed at marginal rates of 39.35% as described above. This closure route would therefore not be recommended,

A formal liquidation has the advantage of securing CGT treatment. This would be beneficial as the maximum CGT rate is only 20% and an annual exempt amount of £6,000 will become available. In addition, business asset disposal relief (`BADR`) will be partially available, which will further reduce the CGT rate to 10%. Providing the payments from CCL occur within three years of the cessation of CCL`s trade the disposal of your shareholding in CCL will qualify for BADR. This is because, throughout the period of two years ending with the cessation of trade, (i) CCL is your personal company (i.e. you hold at least 5% of the ordinary shares and any attached rights); (ii) CCL is a trading company, and; (iii) you are a director of the company. The reason only partial relief is available is because there is a lifetime limit of £1,000,000 of qualifying disposals. You have already used £650,000 of this following the disposal of your business in 2021, leaving only £350,000 remaining.

The benefit of lower CGT rates means, despite liquidators being expensive, a formal liquidation would be the recommended closure route.

Appendix II shows that without mitigation (see below) a T&A sale followed by a formal liquidation will result in net of tax funds for yourself of £846,402.

Dissolution of CRL

Before the formal liquidation of CCL, its subsidiary CRL could simply be struck off. As part of this CRL`s cash of £1,000 could be repaid to CCL. No chargeable gain would arise as the `proceeds` (i.e. returned cash) would simply equal CCL`s base cost.

Possible Mitigation

Negligible Value Claim

A negligible value claim should be made in relation to CCL`s shareholding in Crowley Glass Ltd. This is because Crowley Glass Ltd entered liquidation on 1 March 2024 with no prospect of any value being returned to shareholders. A negligible value claim treats the shares as being sold and immediately reacquired for market value (i.e. presumably nil) at the time the claim is made (or an earlier time, providing this is on or after the first day of the AP ending no more than two years before the claim being made and the company was of negligible value at that earlier time). This will create an additional allowable capital loss of £50,000 to be offset against the gains arising on the T&A sale.

Because CCL`s shareholding in Crowley Glass Ltd is less than 10% it is noted that the substantial shareholding exemption will not apply to exclude this loss from being available.

Property Fixtures

CCL and SCL could determine the proceeds to use for tax purposes irrespective of the actual sales price used (providing this is below CCL`s original cost or the actual selling price), by making an appropriate claim. The claim could, for example, specify proceeds of £1 for tax purposes. In this way £49,999 of the balancing charge could be avoided. SCL may, however, not agree to go this far (because this would reduce their future capital allowances claim), although a negotiated compromise reduction in proceeds to use may be possible.

Equipment

Here the sale price could also be reduced to, say, tax written down value. Providing SCL can claim capital allowances this would not be open to challenge by HMRC. However, this would reduce actual proceeds within the agreement, so assuming that total proceeds will not be reduced, no overall benefit would accrue (as the proceeds would simply be reallocated to other assets increasing taxable amounts for those assets in a compensatory way).

Overall

Following the above would lead to a reduction in additional taxable profits from the maximum of £421,787 to £303,788 (£169,500 - £67,999 (balancing charge) + £252,287 - £50,000 (gains)). The reduction of £117,999 would lead to a CT saving of £29,500 (£117,999 x 25%), such that, as shown in Appendix II, with mitigation, net of tax funds for yourself becomes £870,002.

Sale of Your Shareholding

General Matters

The alternative to a T&A sale would be to directly sell your shares in CCL to SCL. From your perspective this would be simpler than a T&A sale. There would be no cessation of the trade of CCL, the company would simply continue under new owners. As a consequence, there would not be any CT charges arising from asset disposals etc., or formal liquidation costs. A share sale also involves only one level of taxation and therefore avoids the double tax charge inherent within a T&A sale. CGT would be payable on the sale of your shares, so BADR would also be available as described before (with the exception that in this case the two-year backward-looking period for the conditions to apply runs from the disposal date itself).

Appendix III shows that a direct sale of shares will result in a CGT liability of £118,840, payable by 31 January 2026 (assuming the disposal occurs in the tax year 2024/25). Net of tax funds for yourself will increase to £941,160, demonstrating the benefit of avoiding the additional CT charge that would arise with a T&A sale. If SCL could be persuaded a share sale would therefore be the recommended route.

Using Loan Notes

Rather than taking all the proceeds in cash an alternative would be to receive at least some of the consideration in the form of loan notes issued by SCL, on which interest could be charged. Providing these are denominated in sterling and cannot be converted into another currency they will be qualifying corporate bonds (`QCB`s). The advantage of QCB`s is that the proportion of the total chargeable gain relating to them is not chargeable immediately. Rather this will come into charge as and when the loan notes are redeemed (or sold), possibly over a period of several years.

It should be noted, however, that whilst your shares in CCL qualify for BADR, gains coming into charge upon the redemption of the QCB`s will not (unless you satisfy the conditions for this relief at the time of the disposal, which does not seem likely). To enable the use of your remaining £350,000 BADR lifetime limit (£1,000,000 - £650,000) at least £350,000 of total consideration should therefore be in the form of cash.

Another downside is the commercial risk of the loans not being repaid (maybe because of a future failure of SCL). As QCB`s are exempt assets no allowable capital loss would accrue. Further the `frozen` gain itself would become chargeable, although it is possible to gift the QCB to a charity to avoid this charge.

Any interest paid will be received net of 20% income tax.

Encouraging a Share Sale

CCL will retain responsibility for all its historic liabilities and actions, so SCL would effectively inherit these if they directly bought your shares. From their perspective, particularly because of their previous bad experience in purchasing another company`s shares, this might be regarded as undesirable.

Warranties & Indemnities (`W&I`)

SCL could be offered protection in the form of suitable warranties and indemnities to be included in the sale agreement. A warranty is a contractual factual statement concerning any aspect of CCL`s business (e.g. that there are no bad debts etc). If the warranty is later shown to be incorrect you would be in breach of contract, enabling SCL to seek damages (or even, if significant, rescind the contract). An indemnity is a promise to make payments, normally to the purchaser, if certain liabilities arise. A specific tax indemnity is common to protect the buyer against any unprovided pre-acquisition tax liabilities. Indemnities are usually drafted as creating an adjustment to the sale price (so that any CGT payable would become based on the lower price).

Well drafted W&I may be sufficient to get a share sale agreement over the line. It should be noted that, in particular some warranties are likely to be required by SCL, even with a T&A sale, so this would simply be extending this process. However, SCL may not wish to put themselves into a position where they are solely reliant upon W&I for redress.

Price Reduction

A discount could be offered for a share sale. This could be set at a level such that resulting after tax proceeds are no less than that achievable with a T&A sale. Commercially SCL may well try to negotiate a price reduction in any event, particularly, as the contingent tax within CCL`s chargeable assets (essentially due to CCL`s lower original base costs) would pass to SCL with a share sale. Against this the value of the capital loss realisable by a negligible value claim would also pass to SCL.

Stamp Taxes

With a share sale stamp duty of £5,300 (£1,060,000 x 0.5%) would be payable by SCL. This compares favourably with stamp duty land tax (`SDLT`) payable with a T&A sale, where the sale of the original property and new factory would likely be treated as linked transactions such that the SDLT payable would be £22,000 ((£150,000 x nil) + (£100,000 x 2%) + (£400,000 x 5%)).

Use CRL as the sale vehicle

CRL is a dormant company which has not traded and therefore has no accumulated potentially adverse `history` to transfer to SCL. Its use as the sale vehicle may therefore appeal to SCL as a way of acquiring the selected assets it wants free of any unforeseen liabilities. This would involve transferring the selected assets required to CRL, with this company then being sold to SCL.

CCL owns at least 75% of the ordinary shares of CRL, so CRL is within CCL`s chargeable gains group. Chargeable assets transferred to CRL will therefore be initially treated as sold for a price that gives no gain or no loss (i.e. for indexed base cost). Any balancing charges arising can be avoided by CCL and CRL making a joint election for capital allowance purposes such that the relevant assets are transferred at their tax written down value.

After CRL has carried on CCL`s former trade for a short period CCL would sell its shares in CRL to SCL. Because this sale will occur within six years of the assets being transferred a (degrouping) charge will occur. CRL would be treated as disposing of and immediately reacquiring the assets at their MV at the date it received them (thereby creating chargeable gains or losses). However, this charge will be included within CCL`s gain on its share disposal (as additional sale proceeds).

The substantial shareholding exemption (`SSE`) should exempt CCL`s gain (including the degrouping charge) on its share disposal, such that no CT will be payable. This is (broadly) because (i) CCL is disposing of a shareholding of at least 10%, and (ii) CRL is a trading company. There is also a requirement that these conditions are satisfied for a continuous period of 12 months within the six years prior to the disposal. In this regard, however, the time when another group company (i.e. here CCL) carried on the trade can also be taken into account.

The sale of CRL should therefore be tax free, avoiding the double tax charge inherent within a T&A sale. Finally, CCL could be formally liquidated with funds passing to yourself as a capital distribution as described above. This method will not therefore avoid liquidation costs. It should also be noted that whilst the original assets transfers to CRL will be SDLT free upon CRL leaving the group (within three years) SDLT will also become payable by CRL.

A further attraction for SCL of this route would be the tax-free uplift in base costs of the assets it receives within CRL. SCL would probably want to check that CRL has not traded etc., but this should not be too difficult or onerous.

Value Added Tax (`VAT`)

If a T&A sale to SCL occurs this will be a transfer of a going concern (`TOGC`) and outside the scope of VAT. This rule will also apply to the properties as they are both more than three years old. No VAT will therefore be payable on any assets transferred. Within 30 days of ceasing to trade HMRC will need to be informed that no taxable supplies are being made. The company will then be deregistered for VAT.

If a direct share sale occurs CCL will simply continue with its existing VAT registration as before.

If CRL is used, providing CRL undertakes CCL`s former trade for a while and registers for VAT, again no VAT will be payable under the TOGC provisions. Once its trade is transferred CCL will need to deregister as outlined above.

Appendix I

Capital Allowances with Trade and Asset Sale

	Main Pool	SRP
	£	£
TWDV b/f	18,500	0
Additions – equipment	5,000	0
Maximum proceeds (Note 1)	(193,000)	0
Maximum balancing charge (Note 1)	(169,500)	0

Note 1

Maximum proceeds comprise:

	£
Vehicles	75,000
Equipment	50,000
Property fixtures (Note 2)	68,000
	193,000

Disposal of chargeable assets

Intangible asset

	£
Goodwill	
Value	200,000
Less: cost	(10,000)
Indexation allowance	
(278.1 - 144)/144 x 10,000	(9,313)
Chargeable gain	180,687

The purchased goodwill was acquired on 15 July 1994 (i.e. before 1 April 2002). Its sale will therefore give rise to a chargeable gain.

Tangible assets

Office and Warehouse	
Value	250,000
Less: cost	(160,000)
enhancement	(35,000)
Indexation allowance	
(278.1 - 166.6)/166.6 x 160,000	(55,000)*
(278.1 – 217.9)/217.9 x 35,000	
Gain / loss	NIL

* Indexation allowance has been restricted as it cannot create a loss.

New factory

Value	400,000
SBA`s claimed (note 1)	21,600
Less: cost (100,000 + 225,000)	(325,000)
Chargeable gain	96,600

Note 1
Structures and buildings allowances previously claimed amount to £21,600 (£180,000 (£225,000 (i.e. excluding land value) - £45,000 (expenditure qualifying for capital allowances)) x 3% = £5,400 x four years (i.e. AP 30 June 2021 – AP to 30 June 2024 inclusive)).

Note 2
Based upon original cost (the maximum permitted via an appropriate joint election)

Revised CT Payable for Accounting Period ended 30 June 2024

		£	£
`Normal` trading profits (per forecast)			50,000
Additional profits attributable to sale			
Balancing charge		169,500	
Chargeable gains:	Goodwill	180,687	
	New factory	96,600	
Capital loss brought forward		(25,000)	
			421,787
			471,787
CT x 25%			117,947

Appendix II
Net cash available following a trade & asset sale

		No Mitigation	With Mitigation
		£	£
Proceeds from sale		1,009,000	1,009,000
Net cash from assets less creditors retained		51,000	51,000
		1,060,000	1,060,000
Less:	CT on asset sales	(108,447)	(78,947)
	Estimated liquidation costs	(10,000)	(10,000)
Available for capital distribution		941,553	971,053
CGT on capital distribution:			
Distribution		941,553	971,053
Less: cost (note 1)		(284,800)	(284,800)
Chargeable gain		656,753	686,253
Less: annual exempt amount		(6,000)	(6,000)
		650,753	680,253
CGT thereon:	350,000 x 10%	35,000	35,000
	300,753/330,253 x 20% (note 2)	60,151	66,051
		95,151	101,051
Net cash		846,402	870,002

Note 1
9,800 shares were transferred to yourself from Charlotte on a no gain/no loss basis, i.e. for £9,800. The remaining 10,200 shares were acquired upon the death of Charlotte at their probate value of £275,000. Your total base cost is therefore £284,800.

Note 2
You do not have any unused basic rate band as your taxable income of £47,430 (25,000 + 35,000 – 12,570) exceeds £37,700. Even if this were not the case, any remaining basic rate band would be allocated to gains qualifying for BADR. The CGT rate applicable to gains exceeding £350,000 will therefore be 20%.

Appendix III
Net cash available following a share sale

		£
Proceeds		1,060,000
Less: cost		(284,800)
		_________
Chargeable gain		775,200
Less: annual exempt amount		(6,000)
		_________
		769,200
		=========
CGT thereon:	350,000 x 10%	35,000
	419,200 x 20%	83,840
		_________
		118,840
		=========
Net cash		941,160
		=========