The Chartered Institute of Taxation

Application and Professional Skills

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Suggested answer

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Expansion of Charl Communications

Introduction

This report is divided into two sections. The first examines raising funds to finance the expansion of Charl Communications (`CC`). The second examines the expansion of your business over the next five years.

This report is based on current tax rates and rules and assumes that these continue into the near future. The report`s first part is restricted to examining UK tax implications only - you may wish to seek further advice regarding any Morovan tax implications. The second part is based upon annual taxable profits of £100,000 until the planned sale of the business after a five-year period and that your Morovan house is sold to fund the business expansion.

Executive Summary

The preferred asset to sell would be your Morovan house. No UK tax would be payable thus providing all the funds required to develop CC.

An incorporation of CC is recommended. This will achieve overall tax savings as well as reducing your personal risk exposure.

A sale of the goodwill and other assets of CC on loan account to the new company is recommended. This would enable tax free withdrawals of the loan account over your remaining business ownership.

It is recommended that a joint election to transfer relevant plant and machinery at their tax written down value is made upon the incorporation, to avoid a taxable balancing charge being created.

It is also recommended that the new equipment is purchased by the company not the ceasing sole trader to maximise capital allowances.

It is also recommended that the new company does not take over your current VAT number.

Funding Business Expansion

You do not wish to sell your UK home so, to raise £225,000 to purchase equipment and business premises a choice will need to be made from your other significant assets.

Shares in Morodby Communications Inc

Because these shares were acquired when you were formerly UK resident, to escape capital gains tax (`CGT`) they would need to be disposed whilst you are non-UK resident (`NUR`) and you remain NUR until 31 October 2022 (five years after becoming NUR). As you do not wish to do this their disposal would result in a CGT liability calculated as the difference between sale proceeds and their original base cost.

These shares were transferred from your former wife after the tax year of separation (2016/17) so will have a base cost of £50,000. A gain of £187,700 (£250,000 - £50,000 - £12,300 (annual exempt amount (`AEA`))) would therefore arise giving a CGT liability of £37,540 (£187,700 x 20%) payable by 31 January 2023 (if sold in the 2021/22 tax year). After tax proceeds would therefore be £212,460.

Morovan House

Because this house was acquired after you became NUR its disposal will not be treated as described above and would escape CGT if sold whilst NUR. Further even if sold within nine months of resuming UK residence, principle residence relief will be available to entirely exempt any gain arising. Its disposal at any point in the 2021/22 tax year will therefore result in the full proceeds being available.

Conclusion

If it could happen quickly your Morovan house would be the preferred asset to sell. The sale of your shareholding in 2021/22 might be faster but because you need to return to the UK before 1 November 2022 CGT would be payable. Assuming you retain sufficient proceeds to pay the CGT due by 31 January 2023 a funding shortfall of approximately £12,500 arises which could perhaps be made up from the cash held by CC.

<u>Expansion of Charl Communications (`CC`)</u>

Principal Options

CC could be developed by either continuing as a sole trader or via a limited company.

Continuing as a Sole Trader

Appendix A shows if CC`s annual taxable profits increase to £100,000 total taxes, comprising income tax, Class 4 & Class 2 national insurance contributions (`C4NIC` & `C2NIC` respectively), of £41,629 arise, with approximately £208,000 over five years. Because income exceeds £100,000 your personal allowance entitlement will be reduced.

Because you have owned CC for at least two years, business asset disposal relief (`BADR`), giving a 10% CGT rate for disposals of qualifying assets, will be available when the business is sold in five years. Currently the only base cost available, to match against future sale proceeds, is £20,000 relating to the specialist equipment so assuming this is retained until the business is sold the approximate CGT would be £48,000 ((£500,000 sale proceeds - £20,000) x 10%). Aggregate taxes will therefore be approximately £262,000.

Continuing CC on a sole trader basis will, however mean that your personal assets remain at risk. It may be possible to reduce this risk with appropriate insurance, although it is unlikely that all risk can be covered in this way. Whilst any insurance premiums paid are likely to be tax deductible annual premiums could be expensive and most profits would remain taxable at high marginal rates.

Limited company (`company`)

Introduction

Alternatively, the trade and assets (`T&A`) of CC could be transferred to a company formed for this purpose, a process known as incorporation. The T&A could then be sold to the company either in exchange for shares to be issued to yourself, or for cash. If the latter, because the company may not have any funds initially, this is often in the form of a loan account set up in your name to be paid, cashflow permitting, as required. Incorporation could also proceed by gifting T&A to the company.

You will become a director, as well as the sole shareholder, of the company.

Risk Mitigation

Companies are commonly used to reduce personal risk. Because the company is a separate legal entity it will be liable for its own debts. Your personal risk is usually only limited to any unpaid amount (if any) on shares issued to you.

This protection can be restricted in certain circumstances. For example, if a business becomes insolvent and continues trading with the intent to defraud (fraudulent trading) directors can be personally liable for some or all of the company`s debts.

The company could mitigate its own risk with appropriate insurance.

Tax on profits following incorporation

Companies pay corporation tax (`CT`) at 19% on their taxable profits (including any gains) which compares very favourably with developing CC as a sole trader.

You will only pay personal tax on taxable amounts taken from the company, such as salary or dividends, so you will have more control over when and how you are taxed. It is worthwhile noting that any repayments of a loan account set up in your name upon incorporation are not taxable.

If you take a salary both you and the company will be liable to Class 1 national insurance contributions (`C1NIC`). This is charged at relatively high rates (12% for employees on salary above £9,500 and 2% above £50,000 and 13.8% for employers on salary above £8,788). To minimise C1NIC a low salary could be paid topped up with dividends (or possibly rental payments – see later), which are NIC-free.

Dividends are taxed as the top slice of an individual`s income at 0% (for the first £2,000), 7.5% (to the extent the dividend falls in the basic rate band), 32.5% (between the basic rate band and £150,000) and 38.1% (if taxable income exceeds £150,000).

Unlike salary, dividends are not deductible for CT purposes.

As well as reducing risk an incorporation, as explained below, could also help reduce the overall incidence of taxation going forward.

Appendix A also shows the projected position if the business is developed via a company. This assumes that the residual profits of £81,000 after paying corporation tax of £19,000 are paid as dividends. In reality this may not be the case as your personal circumstances may mean that lower amounts are required. If needed you may also choose to pay a small salary to attract some C1NIC credits to accumulate towards, for example, your state pension.

On the assumptions made Appendix A shows that incorporation produces savings in total taxes of approximately £24-25,000 over the five-year period. As explained further below this position could be further improved.

Because incorporation could achieve overall tax savings as well as reducing personal risk exposure this would be the recommended business expansion route.

Further Considerations

Whether assets are sold or gifted to the company disposals will occur for CGT purposes. Because you and the company will be connected these disposals are deemed to occur at market value (`MV`).

The actual method needs to be carefully considered as this will affect (i) the extent to which any CGT upon incorporation will occur; (ii) how profits generated over the next five years can be withdrawn from the company, and; (iii) the cost of shares (or assets transferred) which would be deductible and hence any CGT payable upon the future sale of the business.

CGT Upon Incorporation

There are currently two chargeable assets comprising goodwill and an item of specialist equipment (which has a current MV in excess of its original cost). None of the other items of equipment are chargeable because they originally cost and are currently worth less than £6,000.

BADR will be available on the gain of £15,000 (£35,000 - £20,000) relating to the specialist equipment.

The gain on the disposal of goodwill will be £50,000 as you have no base cost for this asset. Because you will own more than 5% of the shares BADR will not be available for the goodwill so CGT at the rate of 20% will arise. It is worth noting that any available AEA should be allocated to this gain (attracting the highest CGT rate) to minimise any potential CGT arising.

Without mitigation (see below) CGT of £11,500 ((£15,000 x 10%) + (£50,000 x 20%)) arises which would be payable by 31 January following the end of the tax year in which the incorporation occurs.

Mitigation of Incorporation Gains

It is possible to reduce the CGT payable upon incorporation to nil using either incorporation relief or gift relief.

Incorporation Relief (`IR`)

IR will automatically be available if all the assets are transferred to the company and at least some of the consideration is in the form of shares. The relief works by reducing the base cost of the shares (MV of assets at incorporation) available for future use by the incorporation gains. If some cash is received the relief is proportionately restricted.

Appendix B shows the position over the five-year period if full incorporation relief is claimed. Total taxes over this period will approximate £225,000 with no initial CGT upon incorporation and £35,300 upon a future share sale. As before the assumption is that all available profits are paid out as dividends.

It is also assumed that BADR will be available when the shares are sold. This should be the case as you will have held them for at least two years and (i) will have been a director and (ii) the company will be a trading company throughout this qualifying period.

The base cost of any chargeable assets transferred to the company will be their MV.

I note that you wish to retain the business premises personally so, if IR is to be used it would be recommended that the incorporation occurs before you personally acquired them.

Disapplication of IR

It is possible to disapply IR such that the CGT of £11,500 would become payable. This would not, however, be recommended as the £6,500 ((£212,000 - £147,000) x 10%) tax savings generated from the resulting increased base cost of your shares will not compensate for the initial £11,500 CGT becoming payable.

Gift relief (`GR`)

Alternatively, a joint election could be made between yourself and the company, on an asset-by-asset basis, to offset the incorporation gains against the MV of each individual asset.

This would mean that the base cost of the goodwill and specialist equipment held by the company, to be used in a future disposal of those assets by the company, will be reduced to nil (£50,000 - £50,000) and £20,000 (£35,000 - £15,000) respectively. This would increase any corporation tax when the company subsequently disposes these assets.

Additionally, your base cost in the shares will simply be the amount that you pay for them, which could be very small, for example if the initial share capital of the company is one hundred ordinary £1 shares the base cost would be just £100.

GR does, however, introduce the possibility that the remaining assets could be sold to the company, creating a loan account of £127,000 (£212,000 - £85,000), which could be repaid to you tax-free over the next five years. The effect would be that whilst the base cost in your shares is substantially reduced this would be more than compensated for by a reduction in dividends taxed at 32.5%. As shown in Appendix B the overall impact of this route would be a tax saving of approximately £26-27,000 compared to using IR.

Unlike with IR, using this route would mean that the business premises could be acquired prior to incorporation and retained personally.

Simple initial sale

The situation could be improved further by maximising the loan account by simply selling all the assets, to the company. Excluding cash, the maximum loan account could be £212,000. As shown in Appendix B further net savings of around £16,000 could be achieved adopting this route. Whilst the initial £11,500 CGT liability would be payable, tax on dividends could be further reduced over the five-year period by approximately £27,500 (£85000 (£212,000 - £127,000) x 32.5%).

Again, it would not matter when the business premises are acquired.

This would therefore be the recommended route. It is worthwhile noting that there is scope for further improvement if annual dividends could be further reduced by up to £7600 (so that all dividends become taxed at 7.5% rather than 32.5%).

Other Matters

Trade and Asset Sale

Considering the sale of the business in five years' time a share sale is generally preferred from a tax perspective rather than a T&A sale as there will only be one tier of taxation. With a T&A sale a double tax charge may arise. The company will pay CT on any gains it realises with further tax upon the extraction of the proceeds. Company gains will be minimised if the base cost in the underlying assets is as high as possible. A simple initial sale (or using IR) would be better in this regard as using GR results in asset base costs being reduced upon incorporation.

The final extraction of proceeds would either be in the form of a dividend taxed at rates as high as 38.1%, or if the company is formally would up in the form of a capital distribution subject to CGT. Because a capital distribution would likely attract BADR this would be preferred.

Holding Business Premises Personally

Holding the business premises personally would permit the receipt of NIC-free rent from the company. The company could obtain a tax deduction for the rent charged and you would need to report this as property income on your tax return.

If these premises have been used by the company for at least two years (and you have owned them for at least three years) and you sell them within three years of selling at least 5% of your company shares this would be regarded as an associated disposal potentially attracting a CGT rate of 10% via BADR. It is important to note, however, that BADR will be proportionally restricted depending upon the extent to which a full commercial rent has been charged (ie if full rent no BADR; if no rent full BADR). You will therefore need to balance obtaining BADR when this property is disposed against any tax benefits of extracting rents from the company.

Income Tax

Cessation of CC

An incorporation would bring about the cessation of CC for income tax purposes. As your accounts have always been made up to 31 March the final assessment for the business for the 2021/22 tax year will be the profits for the period from 1 April 2021 to the incorporation date.

Capital Allowances

Proposed Purchase
Whether you continue as a sole trader or company the £25,000 cost for the new equipment will be deductible (as 100% annual investment allowance (AIA)) against profits for the period in which the equipment is purchased.

Incorporation

No capital allowances (including an AIA) for any asset additions can be claimed in the final period as a sole trader (so we would advise a delay in buying the new equipment until the company is established). If the underlying assets are sold a disposal value will need to be entered in the capital allowance pools. This value will be the lower of actual consideration and original cost, with any excess value taxed as a chargeable gain. This disposal value would therefore be £88,000 for the plant & machinery pool (£58,000 (equipment) - £15,000 (cost adjustment for specialist equipment) + £45,000 (vans)) and £12,000 for the special rate pool which would give a taxable net balancing charge of £74,618 (£88,000 + £12,000 - £25,382).

The company would use these figures to claim future capital allowances. As you and the company are connected it will not be possible to claim any 100% annual investment allowances.

As you and the company will be connected the balancing charge could be avoided by making a joint election such that the disposal value is deemed to be the tax written down value. Future capital allowances available in the company would be reduced but the tax benefit lost in the company would be at 19% compared to the 40% personal tax charge that would arise without the election. Such an election would therefore be recommended.

Stock

Upon the cessation of CC the stock will be deemed to be transferred at MV which would generate additional taxable profits for CC of £5,000 (£25,000 - £20,000).

If the actual sale price used is less than MV (e.g. accounts net book value) a joint election could be made to use the actual consideration rather than MV, generating a small initial tax saving. The company`s stock value would then be this lower value.

VAT

The transfer of CC`s business will be a transfer of a going concern. This means that no VAT will need to be accounted for upon the incorporation. The company will need to carry on the same business and register for VAT from the date the business is transferred.

You will need to personally deregister for VAT within 30 days of CC ceasing. The new company must register for VAT and has the option of taking over your old VAT number but this would mean that if there are any VAT problems these would also transfer across, so this not recommended.

Stamp Duties

There is no stamp duty on new shares issues, including upon incorporation, nor is it charged on the sale of your assets to the company.

As the premises will cost more than £150,000 Stamp Duty Land Tax (`SDLT`) of £1,000 ((£200,000-£150,000) x 2%) will be payable by you on purchase which will be added to the cost of the building when you come to sell it in the future..

Appendix A
Projected Tax - Sole Trader vs Company

	Sole Trader		Company
	£		£
Trading income	100,000		100,000
Other dividend income	19,000		
Personal allowance	(3,000)		
	________		_______
Taxable income	116,000	Profits chargeable	100,000
	=======		=======
		Corporation tax x 19%	19,000
			=======
		Personal taxes:	
		Dividend income	
		Other	19,000
		From company	81,000
		Personal allowance	(12,500)
			_______
		Taxable income	87,500
			=======
Income tax thereon:		Income tax thereon:	
37500 x 20%	7,500	2,000 x 0%	0
59,500 x 40%	23,800		
		35,500 x 7.5%	2,662
2,000 x 0%	0	50,000 x 32.5%	16,250
17,000 x 32.5%	5,525		
	_______		_______
	36,825		18,912
	=======		=======
C4NIC		C1NIC	0
9,500 x 0%	0		=======
40,500 x 9%	3,645		
50,000 x 2%	1,000		
	_______		
	4,645		
	=======		
C2NIC £3.05 x 52 weeks	159		
	=======		
Total taxes	41,629	37,912	
	=======		=======
Over 5 years	208,145		189,560
	=======		=======

Appendix B

	Incorporation relief	Gift relief	No relief
	£	£	£
Base cost of shares	147,000	say 100	say 100
Loan account upon incorporation	0	127,000	212,000
Profits to distribute each year	81,000	55,600	38,600
(Profits – corporation tax – loan account/5 years)			
CGT upon incorporation	0	0	11,500
Corporation tax	19,000	19,000	19,000
Personal tax			
As Appendix A	18,912		
Other dividends			
£4,500 (£19,000 – £12,500 – £2,000 x 7.5%		337	337
Company dividends			
£31,000 x 7.5%		2,325	2,325
£24,600 (£55,600 - £31,000) x 32.5%		7,995	
£ 7,600 (£38,600 - £31,000) x 32.5%			2,470
	37,912	29,657	24,132
Over 5 years	189,560	148,285	120,660
CGT upon share sale *			
(£500,000 - £147,000) x 10%	35,300		
(£500,000 - £100) x 10%		49,990	49,990
Aggregate Projected Taxes	224,860	198,275	182,150

*Ignoring CGT AEA for simplicity