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REPORT TO HORATIO STILES ON

1) THE USE OF SURPLUS FUNDS STILES CONSTRUCTION LTD
2) THE TRANSFER OF SHARES TO PATTI

INTRODUCTION

As requested in the letter from Horatio Stiles of 30 April 2018, this report considers:

1) The transfer of your shares to Patti in your lifetime or on your death.
2) The use of surplus funds of Stiles Construction Limited ("SC Ltd") to either
    a. Purchase a small industrial unit to rent out; or
    b. Transfer to you either directly or as a company pension contribution

EXECUTIVE SUMMARY

SC Ltd has historically been a trading company. The retention of funds within the business and the acquisition of investment assets, such as quoted shares and the industrial unit could affect that status. This is critical because it affects the Capital Gains Tax ("CGT") and Inheritance Tax ("IHT") Reliefs available on a disposal of your shares either during your lifetime or on death. It is preferable that you do not increase investment activities in the company (for example by acquiring and investment property) as this will preserve the availability of CGT reliefs.

Due to the potential for double tax (CGT and IHT), provided the intention is that the shares should be retained in the family indefinitely, it is preferable that the transfer to Patti takes place on your death rather than in your lifetime.

Whilst withdrawing funds from the company will reduce the proportion of the company's value represented by non-trading activities, there will be a significant personal tax cost if you withdraw the funds directly. That personal tax charge will be circumvented to the extent that company pension contributions are paid. This will also secure a corporation tax deduction for the expense and also result in the funds being in a tax effective shelter. Relief for pension contributions is limited and if excess contributions are paid there is an "annual allowance charge" on you. Therefore, if £185,000 is to be paid out of the company, £45,000 of this should be deferred until future tax years.

GIFT OF SHARES

Background

There are three important reliefs which may be available from CGT (Entrepreneurs' Relief and Gift Relief) and IHT (Business Property Relief). To some extent, all these reliefs are dependent on the company not being engaged in investment activities. The use of surplus funds could affect the status of the company and hence the availability of these reliefs and it is therefore useful to first understand the position on a lifetime or death gift with no relief. The impact of reliefs can then be explored and finally a conclusion can be reached on whether a gift of shares should be made in your lifetime or on death.

Lifetime Gift of Shares to Patti – No Relief

As Patti is your daughter, she is "connected" to you for CGT purposes. Therefore, irrespective of any actual proceeds, you will be subject to CGT as though you had disposed of the shares at their current market value, which appears to be around £1.2 million. Your base cost of the shares, which can be deducted to arrive at the gain, is their market value of £13,000 when they were transferred to you on your father's death. The gain will also be reduced by your annual exemption (currently £11,500).

As you pay Income Tax at the higher rates, the rate of CGT which will apply to the gain will be 20%. Before considering reliefs, this therefore means that there will be a CGT liability of some £235,100 on a lifetime gift which you would need to fund.

There is no immediate IHT charge on a lifetime gift of assets to another individual (a "Potentially Exempt Transfer"). If you survive for 7 years there will never be an IHT charge on this gift. You have survived more than 7 years since the gift of your house and therefore IHT will never become payable on this gift unless you reoccupy it.

If you die within 7 years of the gift of shares to Patti, IHT at 40% may be payable, although the whole of your nil rate band of (currently £325,000) will be available to reduce any such IHT charge on your death (this analysis could change if you re-occupy the house and if this is likely you should let us know and we will advise on the possible consequences). If a deceased spouse did not use all of their nil rate band, a transfer of the unused proportion may be available, but in your case on Sheila's death the whole of her nil rate band was used. The value of the gift will be the value at the time of the gift of £1.2 million. You would be able to deduct two annual exemptions of £3,000 (for year of the gift and the preceding year as that was not used). Before considering reliefs and after deducting the nil rate band of £325,000, the IHT payable would therefore be £347,600 (in addition to the CGT paid on a lifetime gift).

Patti would need to pay this. As it is such a large sum this may be difficult and may require her to raise a mortgage on her home, to extract funds in a taxable form from the company, or to sell some of the shares. None of these will be particularly attractive options. As a practical matter, if you give away the shares, you will no longer be entitled to receive dividends and would need to be satisfied that you would have sufficient income from other sources.

Shares Left to Patti in Will – No Relief

There is no CGT on death. The basic position ignoring reliefs is that IHT will be payable at 40% on the value of your assets at the time of your death, subject to a nil rate band of £325,000 (which may be reduced for any lifetime gifts). Again, this would be an issue as the IHT would need to be paid by your estate which may not have enough cash to meet the liability.

Patti would receive the shares at their market value at the time of your death which means that on a subsequent sale she would only pay CGT on any uplift from their value at that time.

Ignoring reliefs, the decision would therefore require the risk of double taxation (CGT and IHT) which could arise if you die within 7 years of a lifetime gift to be balanced with any additional IHT from the growth in value of the shares by the time of your death if the gift is on death.

Entrepreneurs' Relief

Providing all the qualifying conditions are met and a claim is made, Entrepreneurs' Relief reduces the rate of CGT for a higher rate taxpayer to 10%. There are three qualifying conditions which must all be met during the 12 months before the gift:

1) The shares are in a company which is the taxpayer's personal company (one where the taxpayer owns at least 5% of the ordinary share capital and can exercise at least 5% of the voting rights by virtue of that shareholding),
2) The taxpayer is an officer or employee of that company; and
3) The company is either a trading company or holding company of a trading group.

You clearly meet conditions 1 and 2. Condition 3 is the one of concern however. Whilst the normal company activities are clearly trading, this is not the case with the holding of cash in a deposit account, investment in quoted shares or the holding of an investment property.

A trading company is defined as a company whose activities do not include to a *substantial* extent *non-trading activities*. The question is therefore whether the non-trading activities are, or will become, substantial.

HMRC guidance indicates that unless the funds are locked into long term investments, particularly if those investments are risky in nature, the mere holding of undistributed surplus cash derived from trading operations should not amount to an activity and should therefore not affect the availability of the relief. Even if it did amount to an activity the reason for holding the cash would then need to be considered. If, for example, the cash is being held to meet working capital requirements of the business (for example to assist in trade expansion) it could be argued that the cash is being held for a trading purpose and therefore simply counts as part of the trading activities.

The inference from the above, however, is that holding quoted shares as an investment will amount to a non-trading activity. The investment in property will also amount to a non-trading activity.

Having identified non-trading activities, the next step is to consider whether the extent of those activities is substantial. HMRC regard substantial as being greater than 20% of total activities being performed measured by reference to three factors:

1. The amount of income from non-trading activities
2. The extent to which the asset base of the company includes assets held for non-trading activities
3. The time or expenses involved in undertaking the non-trading activities

HMRC guidance indicates that the position will be analysed 'in the round' and over a reasonable time period with a balanced conclusion then reached. With regard to considering a company's asset base it is worth pointing out that it is the current market value of assets that will need to be considered. This may be of relevance to the freehold property held by SC Ltd which may be worth quite a bit more than its original cost. The value of any off balance sheet items, notably goodwill, will also need to be taken into account.

Applying these tests to SC Ltd, it is unlikely that at present the non-trading activities would be regarded as substantial (the time requirements are limited; the quoted shareholding is small in comparison to the overall assets; little income is generated compared to the overall income of the business and the surplus cash appears to be fairly recent). Accordingly, Entrepreneurs' Relief should be available on the proposed gift of the shares. Long-term retention of cash in the deposit account with no clear trading use of the funds could however jeopardise the relief.

If you decide to use the surplus funds to acquire the commercial unit as an investment property to derive a rental income for the company this will be regarded as a non-trading activity for the purposes of applying the 'substantial' tests. Given the likely purchase price and the value of the company, there is a significant risk that the non-trading activities would be regarded as "substantial" and Entrepreneurs' Relief would be denied.

Careful consideration will therefore be required going forward if you are considering increasing the company's share portfolio and/or acquiring an investment property.

Gift Relief

Where the conditions are met and a joint claim is made by the donor and donee, Gift Relief avoids an immediate CGT charge by deeming the proceeds to be equal to the donor's base cost. This means that on a future sale of the shares Patti would have your base cost rather than the market value at the time of the gift. If she does not qualify for Entrepreneurs' Relief at that time but you would have done at the time of the gift, making the claim for relief could increase the total CGT payable.

The relief only applies to business assets which include shares in trading companies which are either unquoted or are the donor's personal trading company (same definition as for Entrepreneurs Relief above). Again undertaking further non-trading activity could prevent relief.

The claim needs to be made within four years of the end of the tax year in which the disposal occurs. In addition, if Patti becomes non-resident within the six years following the year of the gift, the gain which would otherwise have arisen on your gift to her will become chargeable on her.

Gift Relief can only apply to the trading portion of chargeable assets held by a company. So even if a company does not fall foul of the substantial activities test, it will be restricted if the company owns non-trading assets (such as an investment property or an investment portfolio of quoted shares). In this event the relief is restricted by applying the following fraction to the gain: Chargeable business assets/Total chargeable assets

Business Property Relief ("BPR")

BPR is given at the rate of 100% against IHT for either qualifying lifetime or death transfers of unquoted shares providing:

1) On a death transfer they have been owned by the donor for at least two years prior to the transfer
2) On a lifetime transfer, the donee must still own the shares at the time of the donor's death and they must still qualify as relevant business property at that time.
3) The underlying business being carried on is 'wholly or mainly' a trading one.

As with the CGT reliefs, the last test can be difficult to apply in the case of a company whose underlying business comprises both trading and non-trading elements. The first point to note however is that the trading test is a 'wholly or mainly' 50% test rather than the 80% trading test used for CGT.

Even for a company satisfying the 'wholly or mainly' test, there is a restriction for 'excepted assets'. These are defined as (i) assets which are not used for business purposes throughout the two-year period preceding the transfer; or (ii) assets not required for future use in the business. In this regard there is a distinction between "business" and "trade". Whilst the letting of property is not a trade, it is a business. Therefore, provided the 50% test is met, the let property will not cause relief to be restricted through being an excepted asset. Significant cash deposits not required for working capital and share investments will however be excepted assets.

Conclusion on Gift of Shares

It is quite clear that the consequence of increased non-trading activities is that CGT reliefs for a lifetime gift may not be available. Even if available, from a CGT perspective a better outcome in the round for you and Patti will be obtained by a gift on death. This is because Entrepreneurs' Relief only reduces the amount of CGT payable rather than eliminating it and Gift Relief only defers it whereas a gift on death eliminates the CGT and gives Patti the then market value of the shares as her base cost for her shares. In addition, in that interim period since she will not own the shares, they will be protected in the event, for example, of her divorce (should she marry).

In relation to IHT, if BPR is not available, there is an advantage in making a lifetime gift in the hope that you survive for 7 years so that no IHT will be payable.

Whilst the investment property may not affect BPR, it is highly likely to affect CGT reliefs. In order to preserve flexibility (for example if a fantastic offer for the company was received), it would be better to not invest in property.

Overall and assuming that the company will be retained in the family indefinitely, the best outcome will be to make the gift of the shares to Patti on your death and to ensure any non-trading activity and the holding of what would be excepted assets is restricted. If you want to do something in your lifetime, you could consider small annual lifetime gifts of shares producing gains within your CGT annual exemption

WITHDRAWAL OF FUNDS

Taxation of Investment Income if Funds Retained

Bank interest will be charged to corporation tax on an accruals basis (i.e. the interest due for the accounting period rather than the amount paid) under the “loan relationship” rules as a non-trading profit. This is netted against any non-trading loan relationship debits (e.g. if the company takes out a loan to buy the property) to arrive at a net non-trade profit (or deficit). The interest currently paid is on a loan to acquire some equipment used in the company’s trade and is therefore for a trading purpose and is simply deducted in arriving at the trading profits.

As regards the quoted shares acquired by SC Ltd, dividends received by it from UK companies are not liable to corporation tax.

If SC Ltd buys an investment property, any net rental income would be taxed separately as being derived from a property business rather than from the company’s trade. Net rental income will be determined on an accruals basis by netting rental income receivable from any revenue expenses incurred in connection with the letting (repairs, insurance etc.). If a loss arises, this can be deducted from other profits that the company makes in the same accounting period or, if this is not possible, carried forward for future use against any profits that the company makes in subsequent accounting periods.

Capital allowances would be available on any fixtures within the unit and should you proceed with the purchase information should be obtained from the vendors on the capital allowances history of the property as part of the contractual arrangements for purchase.

If the purchase price for a small industrial unit exceeds £150,000, Stamp Duty Land Tax (“SDLT”) of 2% of the excess will be payable. If VAT is charged to you on the purchase of the property this will increase the consideration for SDLT purposes and also an “Option to Tax” will need to be considered as without it that VAT will not be recoverable. Making the option would mean that you would need to charge VAT to your tenants, which could make the property less attractive if they are not VAT registered or are making primarily exempt supplies.

Corporation tax will be payable on any gains arising from a disposal of SC Ltd’s investment property or quoted shares. This will be calculated as the difference between sales proceeds and the acquisition cost. As holdings of shares in a particular company may be acquired in tranches at different prices and times, there are special rules to determine the cost which can be deducted. Unless shares are held for less than 30 days, this will normally be a proportion of the total cost of the entire holding of the shares.

If a capital loss arises, this can be deducted from other gains made in the same accounting period or carried forward to relieve chargeable gains made in future accounting periods. Indexation allowance cannot be used to create or increase a loss.

Direct Withdrawal

If you withdraw funds of say £185,000, this will remove the risk to the CGT and IHT reliefs discussed above. If withdrawn directly, this would be as a dividend or a bonus. If taken as bonus it would be subject to income tax at your marginal tax rate and 2% employee’s class 1 National Insurance (“NI”) contributions in your hands whilst SC Ltd will have to account for employer’s NI contributions at 13.8%. As your total income would exceed £100,000 your personal allowance would be lost (giving an effective rate of tax of 60% on £23,700 of the bonus) and you would pay 45% tax on income over £150,000. The bonus and employers' NI would be deductible for corporation tax purposes which would fully relieve the anticipated taxable profits of £120,000 for the year ended 31 March 2019 and create a trading loss which could be carried back against the profits for the year ended 31 March 2018 resulting in a repayment of tax from the earlier year.

The payment of an additional net dividend of £185,000 would again result in a large increase in your personal tax liability through the loss of your personal allowance and paying tax at the dividend additional rate of 38.1% on part of it and at 32.5% on the balance. The rates of personal tax on dividends are significantly lower than for a bonus and no NI arises in respect of them and therefore they are more attractive from your perspective. As far as the company is concerned, there is however no corporation tax relief for dividends paid (which means relief at 19% is lost) but on the other hand there is no employers' NI at 13,8% to pay.

Pension Contribution

Whilst personal withdrawal using dividends is likely to be cheaper overall, extraction of the amount whether by way of bonus or dividend will result in significant additional personal tax liabilities arising.

In contrast, there may be no Income Tax liability on pension contributions up to certain limits and in addition corporation tax relief is obtained by the company.

If you are to avoid an annual allowance charge in respect of the payment of a pension contribution, the maximum contribution that can be paid each year is £40,000, plus any unused amounts from the previous three tax years. If your income is more than £110,000 ignoring employer contributions and £150,000 adding employer contributions to you income, this allowance is tapered away. As your income will not exceed £110,000, this restriction will not apply to you.

Assuming a one-off contribution of £185,000, the total payments made on your behalf to your pension fund would be £190,000 (£185,000 plus £5,000 (normal employer contribution)). An excess of £150,000 would therefore arise for the 2018/19 tax year. As only £5,000 was paid in the previous three years, you would have £35,000 from each of those years brought forward (a total of £105,000). The excess contribution would therefore be £45,000 (£150,000 - £105,000). If paid, this excess is subject to Income Tax (i.e. the annual allowance charge) at your marginal rate.

It would therefore be advisable to restrict the contribution in 2018/19 to £140,000. The balance could be paid in future tax years.

Conclusion on Surplus Funds

Assuming they are not required in the business and having regard to the impact on tax reliefs, it is recommended that the funds are either extracted by way of company pension contributions, or they remain on deposit within the company.

Fence Chartered Tax Advisers
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