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Answer-to-Question-_1_

Draft report

From: Alice Broom
To: Colin Dust
Date: 9 November 2020
Title: Implications of proposed business structures and future sale

Introduction
In response to your letter dated 26 October 2020, this report will address the implications of the following:
1) Developing the product in a partnership
2) Developing the product in a new company
3) Involving your wife, Estelle, in the business
4) Future sale of the business

Disclaimer
This report is produced for Colin Dust ('you') only and should not be relied upon by any third parties.

Executive summary
We would recommend setting up your new business as a partnership in order to take advantage of the flexible personal losses reliefs, specifically early years trade loss relief. The loss will be relieved on your personal income at 20% and 40%.

You will need to notify HMRC of the partnership commencing within 6 months of the end of the tax year of commencement.

The partnership will need to register for VAT once taxable supplies exceed £85k in year 4. This must be done within 30 days. The partnership must then charge VAT on their sales.

When the business becomes profit making in year 5, we recommend incorporating into a company to utilise R&D tax relief claims and the lower rate of tax on profits. Incorporation relief will available on your chargeable assets when they are transferred to the new company, providing you receive wholly share consideration in return.

We would recommend involving Estelle in the business once it is incorporated into a new company after year 5. We would recommend you personally gift at least 5% of your own holding in the new company as the gift will be no gain no loss for capital gains tax purposes and exempt from inheritance tax.

If Estelle owned at least a 5% shareholding and was a director in the new company, she would also be able to benefit from entrepreneurs relief on the future sale of the shares.

Assuming the partnership is incorporated once it becomes profitable (year 5), entrepreneurs relief will be available on the gain on your future sale of shares. This will tax the whole gain at 10% after your annual exempt amount.

DF Ltd will qualify for the substantial shareholdings exemption on the sale of its share in the new company and the whole gain will be exempt from corporation tax.

Section 1 - Developing the product in a partnership

<u>Legal and administration</u>
If the new business is set up as a partnership, it is recommended that a partnership agreement is put in place to set out the profit sharing ratios (PSR), capital sharing ratios (CSR) and any other legal issues.

A partnership has unlimited liability meaning you will personally be liable to any debts if the business fails. You could potentially lose your personal assets.

A partnership must file annual accounts but will never have its own tax liability. Tax is charged on the partners on their share of the profits.

All profits/losses must be extracted from a partnership each year.

Income tax

Depending on the date in which you commence trading, the partnership must notify HMRC within 6 months of the end of the tax year in which it becomes chargeable to tax.

The profits/losses of the trade would be calculated on an accruals basis and most expenses are deductible against sales. However, private use adjustments will need to be made for any assets used privately and any salaries given to partners will also need to be add back to profits/losses. Therefore, Gary's pay of £20k must be added back each year as he is a partner.

A partnership may alternatively calculate its profits/losses on a cash basis where income is only included in the period it is received and expenses are only included in the period they are paid. Under the cash basis, losses may only be carried forward against future profits so the cash basis will not be beneficial for your new business as it will restrict the use of losses in early years.

Capital allowances may be claimed on most items that are capital in nature. Capital allowances are then deducted from profits/losses. As your partnership will include a corporate partner, it is a mixed partnership and therefore no annual investment allowance is available to the partnership. The partnership will not hold any significant capital items in the first few years so this is not a huge issue. The costs of building the machine are capital in nature and will be added back to the losses in years 1, 2 and 3. However, as the asset is moveable plant and machinery, capital allowances will be available at 18% per annum.

As mentioned above, you will be taxed on your share of the profits/losses. The profits/losses in the first year will be calculated using the opening year rules - i.e. commencement date to the next 5 April. If you commenced trade at the beginning of April, your loss available in year 1 would be 80% of the adjusted taxable loss of £113,600 which is a £90,880 loss. Going forward, it would be recommended to have a partnership year end of 31 March in order to utilise all losses up front.

Once profits are generated in year 5, you would be chargeable to income tax (IT) on your share of the profits at 40% and 45% as this income would push you into the higher rate band for IT purposes.

You would also have to pay class 2 national insurance contributions (NICs) at £3 per week and class 4 NICs at 9% and 2% depending on profit levels. You may need to perform an annual maxima calculation for NICs purposes as you will be employed and self employed.

<u>Loans</u>
As Dust & Flow Products Ltd (DF Ltd) is connected with the partnership, the loan of £100k will incur a notional tax charge for DF Ltd. s455 tax will be charged at 32.5% on the loan if it is not repaid within 9m of their year end. Therefore DF Ltd will have to pay HMRC £32,500 in reference to the loan.

The remaining loan to the partnership from yourself will be interest free and therefore a taxable benefit will arise on you. You will have to pay 40% or 45% IT on the benefit.

Losses

Per the information given, the partnership will make considerable losses in years 1, 2 and 3. As you are charged personally on the partnership profits/losses, these losses will be available to you personally.

There are 4 options available to utilise the losses:
1) Carry forward against profits of the same trade
2) Utilise against net income in the current year and/or the previous tax year
3) Extend to any capital gains in the year
4) Early trade loss relief - losses incurred in the first 4 years of trading may be carried back against net income of the 3 previous tax years.

As you have income from Dust & Flow Products Ltd (DF Ltd), you may offset the first 4 years of partnership losses against 3 previous tax years and generate a tax repayment for yourself.

There is a restriction on the amount of loss relief against non trading income which is the greater of: £50,000 or 25% adjusted net income (total income less gross personal pension contributions).

VAT

Once your taxable supplies exceeds £85,000 (when looking back at the previous 12m), the partnership will need to register for VAT. Per the information provided, this will be in year 4. The partnership must register within 30 days.

The partnership will then need to charge VAT on all sales but can recover input VAT on costs and assets purchased.

Conclusion

Operating as a partnership provides good flexibility for use of losses in your first few years of trading as they can be utilised against personal income.

However, no AIA will be available on future assets as the partnership includes corporate partners.

Additionally, all profits/losses must be extracted each year and you will have unlimited liability.

Section 2 - Developing the product in a new company

Legal and administration
Unlike a partnership, a company would provide limited liability. A shareholder agreement will need to be drafted.

The company must file annual accounts and annual tax return.

It is worth noting that there is no stamp duty payable on the new issue of shares.

Corporation tax
The company must notify HMRC once it commences trading and this must be done within 3 months of the commencement date.

The company will be a close company meaning it has 5 or fewer participators/shareholders. This means any loans it makes to shareholders will be charged to s455 much like DF Ltd above.

Profits/losses of the company will be calculated on the acccruals basis and there is no option for cash basis. Private use adjustments do not need to be made and salary's of shareholders are deductible for CT purpsoes. All income and gains will be taxed at 19%.

Any corporate losses made are less flexible than partnership losses as they are restricted to use within the company.

Therefore, the profits of the first few years must be carried forward against future total profits.

Capital allowances and the full AIA of £1m is available for the company on the future purchase of qualifying assets. Please note the AIA limit reduces to £200k from 1 January 2021.

Research and development (R&D)

R&D tax relief is available to companies that incur costs on research and development activities. The costs must be incurred on a project that seeks to achieve an advance in science or technology. Even if the advancement is not achieved, R&D still takes place and costs may qualify for relief.

From the information provided by you, it may be possible for the new company to make an R&D tax relief claim against its qualifying costs. Specialist advice will need to be taken to ensure the project meets the criteria.

As the company will have less than 500 employees and less than 100m euros turnover, the company will fall under the SME scheme. R&D tax relief is very generous and provides an enhanced deduction of 130% of qualifying costs which will either decrease profits taxable or increase a loss.

In order to qualify the expenditure must be revenue in nature and must meet certain conditions. The following is a summary:
- The expenditure must be in respect of staff costs, externally provided workers, sub contracted activities, software or consumable costs.
- Staff costs are in respect of employees and directors who are directly engaged in R&D and includes salary, employer pension contributions and employer NIC. Costs are apportioned where the person is not fully involved in R&D. Therefore any salary for yours and Gary's work will be a qualifying cost
- Sub contracted labour is also a qualifying cost but the

enhanced deduction is calculated on 65% of the cost, assuming the company and the sub contractor are not connected.
- The plastic and materials for pipes are consumables so will be qualifying costs.
- Other overhead costs are not qualifying.

As the costs must be revenue, the cost of building the machine will not qualify. However, the cost will get 100% first year allowances within the capital allowances computation and will therefore be fully deductible in the year.

If the new company made an R&D claim it will receive an enhanced deduction of 130% in relation to the above qualifying costs. Therefore, the losses in the first 3 years will be increased and a loss may be created in year 4. Generally, these losses will be carried forward and utilised against future total profits.

However, HMRC allow loss making R&D companies to surrender their loss in exchange for a cash repayment. The surrenderable amount is the lower of: unrelieved trading loss or 230% qualifying expenditure. The tax credit is given at 14.5% of the surrenderable amount. This tax credit is preferrable as losses will be utilised at the earliest possible opportunity and provide further funds for the company.

An R&D claim must be made within 2 years of the end of the accounting period and must be disclosed in the tax return.

<u>Loans</u>
The £100k loan provided by DF Ltd to the new company will be treated in the same way as it would be in the partnership.

Your loan to the company would be put on directors loan account. If you did decide to charge interest this income would be taxed at 40% and 45% for you. The company would also have a CT61 quarterly return obligation.

Extraction of profits

Unlike a partnership, any amount of profit can be extracted by the company but no losses may be extracted as they stay within the company.

As you are planning to only extract dividends, these will be taxed at 32.5% and 38.1% on you and you may lose your personal allowance availability. You are also already using your dividend allowance from the dividends in DF Ltd. There are no NICs payable on dividends.

The company may only pay dividends if it has sufficient distributable reserves so you may only receive this income starting from year 5.

VAT

The VAT implications for a company are the same as the partnership above.

Conclusion

Setting up as a company provides you with limited liability. Profits and gains are taxed at a much lower rate than in a partnership.

An R&D tax relief claim may be made in a company whereas this is not available for partnerships. This provides enhanced relief for any qualifying costs and a cash repayment may be generated for the company.

Although the R&D tax relief claim is very attractive in a new company, the utilisation of losses is much more restrictive than with a partnership. Losses in a company are relieved at 19% whereas in a partnership they may be relieved against your total income at 20% and potentially 40%.

Recommendation

We would recommend setting up your new business as a partnership in order to take advantage of the flexible personal losses reliefs, mainly early years trade loss relief. The loss will relieve your personal income at 20% and 40%.

You will need to notify HMRC of the partnership.

The partnership will need to register for VAT once taxable supplies exceeds £85k in year 4.

When the business becomes profit making in year 5, we recommend incorporating into a company to utilise R&D tax relief claims and the lower rate of tax on profits. Incorporation relief will available on your chargeable assets when they are transferred to the new company, providing you receive wholly share consideration in return.

Incorporating will also be beneficial for DF Ltd when they sell their shares as they may qualify for SSE (see more below).

Section 3 - Involving your wife, Estelle, in the business

You wish to involve your wife, Estelle, in the business. When the business is a partnership, you may make her a partner and she will be assessed on any profits/losses on opening year basis like you.

As she only has taxable income of £21,500 (£20,000 + £14,000 - £12,500 personal allowance) it may not be beneficial to involve her straight away as she has limited income she may use the losses against. Therefore, they may be wasted.

She will also hold a percentage of each asset based on the ratio allocated to her.

Once the partnership incorporates, you may provide her with shares, either by issuing new shares or transferring some of your own shares to her.

A new issue of shares may dillute the other shareholding which would not be desirable.

If you gift a proportion of your own shares in the new company to Estelle, no CGT will arise because transactions between spouses are no gain no loss. The gift is also exempt from inheritance tax (IHT).

It would be recommended to transfer at least a 5% holding to Estelle which would reduce your holding to 60%. This is because at least a 5% holding is needed for Estelle's gain on the future sale of shares to qualify for entrepreneurs relief (ER). She would also need to be made a director in order to benefit from ER.

Once she holds shares, sShe may derive income from the shares through a dividend which will be taxed at 7.5% up to her basic rate band and 32.5% above that.

There is no SD payable on the gift of shares.

Recommendation
We would recommend involving Estelle in the business once it is incorporated into a new company after year 5. We would recommend gifting at least 5% of your own holding in the new company as the gift will be no gain no loss for capital gains tax purposes and exempt from inheritance tax.

If Estelle owned at least a 5% shareholding and was a director in the new company, she would also be able to benefit from ER on the future sale of the shares.

Section 4 - Future sale of the business
You mentioned that you wish to sell your business in 10 years time and you believe the value will be £5m.

Whether you are selling a partnership or shares in a company, this will be a chargeable disposal. Capital gains tax (CGT) will be payable on the gain less your annual exempt amount. Assuming you will incorporate after year 5, the proceeds for your shares will be 60% of £5m which is £3m and the cost will be nil. Therefore you will have a gain of £3m.

Generally this would be charged to CGT at 20% as you have utilised your basic rate band.

However, entrepreneurs relief (ER) is available on a material disposal of business assets. This includes the sale of shares in a personal trading company. ER will tax the whole gain at 10% up to the lifetime limit of £10m.

The following conditions must be met:
- You must be an employee or director
- You must hold at least 5% ordinary share capital
- You must meet the conditions for 2 years prior to disposal.

The company must be a trading company. HMRC defines a trading company as one which does not have substantial non trading activities - substantial generally means 20%. The 20% is determined by a number of factors including turnover, assets and time. We have assumed the new company will be trading now and in future.

Therefore, assuming you incorporate at least 2 years before the sale, you will qualify for ER and your gain will be taxed at 10%.

DF Ltd will qualify for the substantial shareholding exemption

(SSE) on the gain on its shares in the new company. This is provided that they hold the shares for at least 12m out of the previous 6 years before sale. The whole gain will be exempt from corporation tax.

Conclusion

Assuming the partnership is incorporated once it becomes profitable (year 5), entrepreneurs relief will be available on the gain on your future sale of shares. This will tax the whole gain at 10% after your annual exempt amount.

DF Ltd will qualify for the substantial shareholdings exemption on the sale of its share in the new company and the whole gain will be exempt from corporation tax.

Appendices

Appendix 1

Year 1

Loss	(150,000)
Add back: Gary's pay	20,000
Add back: machine costs	20,000
Deduct: 18% WDA on machine	(3,600)
Taxable loss	(113,600)