Tax issues on passing on the family company

Whether you are planning to start a business or already have a business up and running, it is important to consider your long term exit strategy. Do you intend to sell the business for as much as you can? Or do you intend to pass it down to your family? If you have not given the matter any real thought stop for a moment and consider the issue. Obviously the commercial considerations are extremely important but what about the tax issues?

In this bulletin we take a look at the key issues to keep in mind in order to minimise capital taxes when passing on a family company. In the space available we are only able to outline the main areas to consider and it is important that detailed advice is sought well in advance of a proposed sale or transfer. In fact, if you have time to think about exit issues when you are first setting up a business, some of the basic foundations for effective planning can be put in place at this early stage.

A long term plan to sell means making sure that the right conditions are in place to minimise the capital gains tax (CGT) on the sale. If you intend for your family to take on the business (and that begs the question whether they want to take it on!), then the primary area of tax planning will be to ensure that inheritance tax (IHT) does not present a problem.

Starting out - why a company?

A business can be set up in several different forms, sole trader, partnership, limited liability partnership or company. The issue of whether or not to incorporate is driven by many different factors of which tax is only one. In general terms, running a business as a company can be beneficial for capital taxes planning because:

- different rights can be given to different types of share, which may make planning more flexible
- many more combinations of ownership are possible
- shares can allow someone an interest in the ownership of the company without them having direct involvement in the management of the business
- shares more easily facilitate the use of trusts.

Why consider a trust?

Trusts are an important way of holding assets. While some of the tax advantages they enjoyed previously have been removed by the 2006 Finance Bill, there are other reasons which make trusts a sensible option to consider.

- You can give away shares but still retain a measure of control by acting as trustee. In this role you are able to exercise any voting rights attaching to the shares, although you must do so for the benefit of the beneficiaries of the trust.
- A trust can enable the shares in a company to be kept away from individuals who might spend or devalue them although they can still benefit, for example, from the income that arises from the asset. It might also be important to protect assets from others. For example, shares given directly to a child might become the subject of a claim from their spouse in a divorce situation. Placing the shares into trust may avoid that problem.
- A trust can enable you to maintain some flexibility in relation to the underlying assets and can allow changes in benefit to take place without having to formally change the ownership.
- Sometimes it is difficult to anticipate now where you would want shares to go in the future. This that can lead to doing nothing at all! A trust allows a transfer of assets to be made without having to make a final decision as to the individuals who should ultimately benefit from them. This can allow the IHT benefits to arise to your own estate.

Continued overleaf >>>

Selling out - make sure that business asset taper relief is available

The sale of shares in an unquoted family trading company should attract business asset taper relief of 75%. The effect of this is that the gain you make on the shares will have an effective tax rate of only 10%. To ensure this there are two basic conditions to satisfy:

- you must have owned the shares for at least two years
- the company must be a pure trading company or any non trading activity must not be substantial.

The first condition is essentially a question of fact. The second one can present more problems. Issues may arise if the company starts to carry on activities beyond pure trading, for example, the company has investment property which it lets commercially. In these situations HMRC will look at the balance between trading and investment activities using a number of possible measures. If, in their view, the non trading activities account for more than 20% of the relevant measure they may take a view that the company has substantial non trading activities and could seek to deny the relief.

> Keep a watch on what is happening and consider decisions in the light of the end objective. For example, if you want to purchase a commercial property for investment it might be advisable to hold the property personally rather than in your company. Personal ownership may provide business asset taper relief on the ultimate gain. The shares in the company may not have that protection as a consequence of the company holding an investment asset.

Issues arising on the disposal of a company

There are a number of possible ways in which shares in a company can be sold and there are CGT issues to think about on each one. Bear in mind that a disposal takes place for CGT purposes when there is a binding contract for sale and not the date on which the deal is completed. This can be a significant factor where a deal is being contemplated around the end of a tax year.

Can I avoid CGT by going abroad?

The simple answer is yes provided you are prepared to be out of the UK (apart from visits averaging no more than 90 days per tax year) for at least five whole UK tax years. If you come back to the UK too soon, the tax bill on the sale of the shares will come home with you. It is sensible to put the tax on deposit for the five years as an incentive to stay abroad. Also remember to take advice on the tax position in the country you plan to live in. Most other countries have a tax year which is calendar year based and the liability you are carefully avoiding in the UK could come home to roost somewhere else.

What about paper for paper transactions?

An exchange of your shares for shares in the purchasing company is not usually a disposal for CGT purposes. You now have the new shares at the price you paid for the old. As there is no disposal for CGT, taper relief has not been triggered. If the new company is a quoted company and you have less than 5% of the shares in that company, you may prejudice the business asset taper that accrued on your old shares.

If you exchange your shares for loan notes, taper relief considerations also come into play if the loan notes are not qualifying corporate bonds (for example, not denominated in sterling or not carrying a commercial rate of interest).

Are ‘earn outs’ worth considering?

An ‘earn out’ involves deferred consideration, for example, cash now plus more cash if certain targets are achieved by the company within a defined period. The CGT rules on such a disposal are complicated but with some careful planning maximum advantage can be taken of business asset taper.

What about a buy back of shares?

If no one else will buy your shares it may be possible for the company to buy back its own shares provided that it has sufficient reserves to do so. Normally a buy back is treated as an income distribution but provided a number of conditions are all fulfilled, the buy back can be treated as a capital distribution and the benefit of business asset taper relief may be obtained. Particular care must be taken in situations where cash resources are insufficient to buy back the shares.

A problem solved and a problem gained!

When shares in a company are sold, careful planning may have ensured that CGT liability was minimised. However, you must also bear in mind that an IHT problem will usually emerge. This is because shares generally qualify for what is known as business property relief (BPR) which is worth 100% of the value of unquoted trading company shares. The relief is not available for cash. So the day before a sale there is no IHT problem, the day after a sale there could be an enormous IHT problem.

Passing on the company tax effectively

Preserving BPR

BPR is a significant relief that should be protected if at all possible. As with taper relief, provided that the company is a trading company there should be no problem unless assets which are not business assets are put into the company. Where a company begins to carry on investment activities there can also be a problem if the level of those activities exceeds 50%. As with taper relief, advice needs to be taken in situations where a company wants to branch out into non trading activities.

Get the shareholding right

The IHT problem caused on the sale of a company can be partly avoided if some IHT planning has already taken place in respect of the shares. If you are just starting up a company and there are other family members to whom you might ultimately want to give shares, consider putting some shares into trust for them at the outset. This will mean that on a sale the value accruing to those trusts will already be outside your estate. The changes in the IHT regime for trusts make early planning in this area even more essential.

Make transfers sooner rather than later

As a company grows and its shares become ever more valuable, so an IHT problem may start to build. Lifetime transfers can be made but they are not immediately protected from IHT because a seven year clock usually runs on these. The risk of the clock stopping increases with age and so the overall IHT risk will increase. This becomes more important if the shares themselves are at risk of not having the benefit of BPR. Transfers into trusts, particularly discretionary trusts, can provide a route to consider but careful advice needs to be taken.

Is your Will tax effective?

It is very easy to ensure that shares in a family company qualify for 100% BPR and then fail to use the relief. This can happen if one spouse, who has owned all the shares, passes those shares to their spouse through their Will and the surviving spouse decides to cash in the shares. The initial transfer will be exempt for IHT but the survivor will have cash and not shares in their estate. On their death the full value of the shares becomes taxable.

There are a number of routes which can be used to ensure that this situation does not arise but careful planning is required, preferably in advance!

Conclusion

In this bulletin we have only been able to outline the issues that must be considered from a tax perspective when selling or passing down the shares in your company. Early planning is sensible and can be very effective. We would be pleased to meet with you to discuss your plans and then to work with you to ensure that whichever way you decide to pass on the business, HMRC will not be the biggest beneficiary.