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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 Briefing we take a look at the key issues to keep in mind in order to minimise capital taxes when passing on a family company. However, 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 will 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. There are some capital tax advantages in using trusts to hold shares and there are important non tax reasons why trusts can be 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 directly given to a child might become the subject of a claim from their spouse in a divorce situation. Placing the shares into a 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 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. At the same time, it can reduce the value of your estate for IHT.

Selling out - make sure that Entrepreneurs' Relief is maximised

The rate of CGT on any disposal is dependent upon the individual's income tax position. Where combined taxable income and gains fall within the basic rate band of £31,865 the gains element will be taxed at 18%. Where that band is exceeded the CGT rate rises to 28%.

A significant disposal of shares in a family company would be likely to push the rate to 28%. However, an important relief is available in the form of Entrepreneurs' Relief (ER) which ensures that gains which qualify for the relief will only bear a CGT rate of 10% on the first £10m of gain (provided not already used on qualifying gains in earlier tax years).

It therefore becomes very important to ensure that every shareholder where possible qualifies for the relief.

Three basic conditions have to be satisfied in order for a gain on shares to qualify:

- the company must be a pure trading company or have insubstantial non trading activities
- the shareholder must have held at least 5% of the voting rights in ordinary shares in the twelve months leading up to the date of disposal and
- the shareholder must have been an officer or employee of the company (not necessarily on a full time basis) again for the whole of the twelve months leading up to the sale.

It is important to look at all the shareholders to see if they meet their conditions. If they do not and there is time (and an inclination) to help them meet the conditions, then get the necessary changes made now. Within a family company this may be easier to do. If the company is particularly valuable trying to increase the number of shareholders and balancing out the shareholdings can make a significant difference. For example, four shareholders sharing equally in a £40m gain will pay less than half of the tax of a single shareholder with the whole gain leaving the family over £5m better off as a result.

Be careful where a trading company starts to get involved with investment activities e.g. letting property. HMRC takes a very tight line on what it regards as substantial non trading (20% is their guidance) and it may be better to remove investment activities to another vehicle rather than prejudice the valuable ER.

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. This is because a non UK resident is not generally liable to UK CGT. The Statutory Residence Test which applies for 2013/14 and onwards provides clear tests which can be used to plan to achieve non UK resident status. However, if previously UK resident, you must also be prepared to be out of the UK for at least five whole years. If you come back to the UK too soon, a tax bill on the sale of the shares will be waiting for you on arrival! It may even be advisable 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. Many 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, ER has not been triggered. Unless you have at least 5% of the voting rights in the new company and remain an employee/officer you will not qualify for ER on any subsequent disposal. You can elect to have the gain treated as arising at the date of exchange but this will bring forward the CGT liability and could cause a cash flow problem in paying the tax bill unless managed.

If you exchange your old shares for loan notes which are non qualifying corporate bonds (for example not denominated in sterling or not carrying a commercial rate of interest) the same provisions apply so you will not generally qualify for ER at all and the election mentioned above will be beneficial.

Where shares are sold in exchange for qualifying corporate bands (QCBs), a CGT gain immediately arises but is normally deferred until the QCBs are cashed. However, any such exchanges will now only obtain ER when cashed in if the ER conditions are still met at that time. This again is unlikely to be the case so an election to charge the gain immediately will need to be made to secure a 10% tax rate.

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 ER.

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 ER may be obtained. Particular care must be taken in situations where cash resources are insufficient to buy back the shares.

A problem solved is 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.

Tax effective succession

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 of your estate.

Make transfers sooner rather than later

As a company grows and its shares become ever more valuable, 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 in lifetime can be an effective way of ensuring that BPR is used but you need to be certain that the relief is and remains available. 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, subject to the availability of the IHT nil rate band of both spouses.

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 Briefing 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.

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