50 Osmaston Road
Derby DE1 2HU
Tel: 01332 345265

The Old Manse
29 St Mary Street Ilkeston
Derbyshire DE7 8AB
Tel: 0115 932 3995

3 Derby Road Ripley
Derbyshire DE5 3EA
Tel: 01773 743325

E-mail:
derby@mabeallen.co.uk
Website:
www.mabeallen.co.uk

Mabe Allen LLP

Chartered Accountants &
Business Advisers

J.P. Allen, FCA, FCCA, MABRP
K.C.G. Slack, FCA, FCCA
B. Sutton, FCA, CTA
C.J. Hopkinson, FCA, FCCA
D.J. Allen, BA (Hons), FCA, FCCA

Registered Auditors

Mabe Allen LLP is a
Limited Liability Partnership
registered in England and Wales.

Partnership Number
OC 308775

Registered Office
50 Osmaston Road,
Derby DE1 2HU

Registered to carry on audit work by the Institute of Chartered Accountants in England and Wales
Regulated for a range of investment business activities by the Association of Chartered Certified Accountants

NEWSLETTER

10-Year Plus Membership!

The Partners of Mabe Allen have celebrated the commitment of their staff by introducing a "10-Year Plus Membership Club"!

Kevin Slack, the Managing Partner, said "many of our staff have been here for over 10 years, with the longest serving employee having completed 32 years and this is something that we should acknowledge and celebrate".

The inaugural celebration event took place on Friday 7th July at the Kedleston Country House where the members and their partners enjoyed a "20s Summer Ball" evening and all dressed accordingly!

The Partners look forward to welcoming other members of staff to the club in the future!

New Joiners

We are also pleased to advise that we have recruited more people into our team since the end of last year and would like to officially welcome:-

Derby office:
Connor Parkin – Junior Trainee Accountant
Rebecca Hughes – Administration Assistant
Amy Notley – Junior Trainee Accountant

Ilkeston office:
Jane Watson – Bookkeeper
Daniel James – Junior Trainee Accountant
Andrew Haskard FCCA – Senior Accountant
Jason Moore FCCA – Senior Accountant

Ripley office:
Chloe Rice – Receptionist/Administrator
Taylor Gent – Junior Trainee Accountant

AUTUMN 2017

Making Tax Digital for Business: plans delayed

The government's much-publicised plans for Making Tax Digital for Business (MTDfB) have taken a radical new direction, giving businesses longer to get ready for change.

MTDfB involves not just mandatory quarterly updates to HMRC, but also makes digital accounting records compulsory. For some unincorporated businesses, including landlords, April 2018 was the proposed start date. There has been much concern about the entire plan, particularly for SMEs, in terms of additional cost and red tape – and also the very rushed timescale.

There is now a lengthier period to prepare and initially, MTDfB will be limited just to the VAT regime.

New timeline

The timeline now proposed makes MTDfB mandatory from April 2019 for businesses with turnover over the VAT threshold (£85,000 at present). They will have to keep digital records, but only for VAT purposes. Such businesses will be able to provide quarterly updates for other taxes if they wish. Similarly, businesses with a turnover below the VAT threshold can choose to make quarterly updates voluntarily.

2020 is the next date in the MTDfB calendar: HMRC say this is the earliest that businesses and landlords will be required to keep digital accounting records and make quarterly updates for taxes other than VAT.

New problems?

The government announcement has to be good news for business. It allows more robust trials of HMRC systems, particularly as regards our access as agents to client information, and it gives time for the software houses to release the necessary software.

But there may be problem areas. There are many special VAT schemes. Partial exemption is one particularly tricky area. So although HMRC are getting online quarterly information for VAT, many businesses do not submit VAT returns direct from software but use spreadsheets. HMRC will start testing MTDfB for VAT later in the year, though only on a very limited basis, with a wider live pilot in Spring 2018. It's still possible that this timeline will involve VAT-registered businesses in quite a sprint for the finish.

Please be assured that if your business is affected by these changes, we will do all that we can to support and advise you through the transition.

Using the Lifetime ISA to buy a first home

Lifetime ISAs could be opened by individuals from April 2017 but it is only now that a reasonable number of providers exist. Are they the right thing for you, or if not you, your children?

Adults under the age of 40 are able to open an account and contribute up to £4,000 per year and receive a 25% bonus from the government after the end of each tax year. If £4,000 is invested, the investment limit for the other types of ISAs falls to £16,000. Funds, including the government bonus, can be used to buy a first home up to £450,000 at any time from 12 months after the first subscription, or can be withdrawn from age 60 completely tax-free. In this article we are considering the first use – as an investment vehicle to fund the purchase of a first home. Is the use of a Lifetime ISA better than the Help to Buy ISA?

Help to Buy ISAs started in 2015. The scheme provides a government bonus to each person who has saved into a Help to Buy ISA at the point the purchase of their first home is completed. The maximum bonus is £3,000 on £12,000 of savings but the maximum that can be invested in the first year is £3,400 (£1,200 in month one followed by 11 monthly payments of £200). You need to have at least £1,600 saved to get the bonus. The bonus is available on homes worth up to £250,000, or £450,000 in London. As the Help to Buy ISA is a type of cash ISA the rule that an individual can only open one cash ISA each tax year comes into play. Some providers will bundle a Help to Buy ISA and a cash ISA together in the same wrapper to get around this issue.

You can have both a Help to Buy and Lifetime ISA at the same time but you will only be able to use the bonus from one of the accounts to purchase your first home.

In a straight comparison of the bonuses the Lifetime ISA provides more, particularly if the timescale for the purchase of a home is some way off. The bonuses each year are higher and are received after the end of each tax year and so can boost investment returns.

Off-plan purchases and Principal Private Residence exemption

An interesting tax case was heard before a First-tier Tribunal this year and has resulted in a victory for the taxpayer. The case is good news for individuals who have bought or who are making off-plan property purchases. Buying off-plan property means purchasing property – typically an apartment – in advance of its completion and has become much more common in the UK in recent years.

If this property is a residence of an individual for all their 'period of ownership' the UK tax regime provides an important relief from a capital gains tax charge. This is known as Principal Private Residence relief (PPR). Partial relief is available if the property is a residence for part of the period. The intriguing question that has been answered by this tax case is - what is the 'period of ownership'? In HMRC's view, their interpretation of tax law resulted in a capital gains tax (CGT) charge of over £61,000. Mr Higgins thought no charge was more appropriate.

Why the difference of opinion?

The case turned on the interpretation of two specific but important provisions in the legislation:

- S28 TCGA 1992 – which stipulates that a person is deemed to have acquired or disposed of an asset when a contract is made and not, if different, the time at which the asset is conveyed.
- S222 TCGA 1992 – which provides that PPR is available if the property has been the main residence of the individual throughout the 'period of ownership'. Partial relief is given if the property has been the main residence for part of the period.

Often there is little difference between the date of the contract (ie there is a binding agreement to buy) and completion of the contract (ie when a person can move into the property). In Mr Higgin's case however, he entered into the contract for the purchase of an apartment in October 2006. Construction did not start on the apartment until 2009, and it was finished in December 2009. The credit crunch in 2007 had held up the developer somewhat. Mr Higgins paid the balance due on completion and moved in on 5 January 2010.

Two years later, Mr Higgins sold the property at a healthy profit.

S28 TCGA is a very useful provision in CGT planning particularly in allowing a taxpayer to decide whether a disposal is made in one tax year rather than another. But HMRC argued the section worked against the taxpayer in this case. They argued that s28 meant that Mr Higgins owned the property from 2006 to 2011. This was his 'period of ownership' for the capital gain and therefore only 2/6ths of the gain was eligible for PPR. Mr Higgins argued that for the purposes of PPR his period of ownership began when he had the right to occupy the property and so the property was his main residence throughout the 'period of ownership'.

The Tribunal agreed with Mr Higgins. The 'period of ownership' is not defined in legislation and should be given its ordinary meaning. A period of ownership of a dwelling house will ordinarily be said to begin on the date the purchase of the dwelling house has been physically and legally completed and the purchaser has the right to occupy.

PAYE and Making Tax Digital

HMRC's Making Tax Digital project is about to make inroads into the PAYE system. Employers will see an increase in the number of tax codes being issued during the tax year. Hopefully that will turn out to be a good thing for employees but only time will tell.

PAYE started to operate from 6 April 1944 as a means of spreading an employee's tax liabilities over the tax year and allowing the amount of tax deducted to vary with variations in weekly or monthly employment income. The tax code was the means by which tax allowances were spread over the course of the year. The system worked well for many years in an era when many employees only had one job and did not frequently change jobs.

The system has however been creaking for some time. Employees may have more than one job, or receive a pension whilst still working. In addition the reductions in the tax free allowance code to estimate taxation of benefits and non-employment income, give rise to many employees paying the wrong amount of tax by the end of each tax year. PAYE now applies to around 41 million individuals – around eight million end the year having either over or underpaid tax. Two thirds of these employees overpay tax and many of these are the lowest paid, earning under £15,000 a year.

What is changing?

The use of the Real Time Information system by employers means HMRC receive employee data much earlier than formerly. According to HMRC:

- *Millions (of taxpayers) will pay less tax on a monthly basis by the end of the tax year because we will catch any overpayments sooner and prevent them from building up.*
- *A smaller number, who previously would have had an unexpected bill at the end of the year, will pay the right tax from the moment their circumstances change, so they will be able to manage their tax payments better.*

Does an employee have to do anything?

No, not in the short term. When HMRC is aware of a change in an individual's circumstances, it will issue a new tax code and will write to the employee regarding the change.

If employees don't understand the change, the letter from HMRC will encourage them to use their Personal Tax Account. This is where the Making Tax Digital project comes in. Personal Tax Accounts have been linked to HMRC internal systems so that they will be pre-populated with income and tax details that HMRC already hold. This includes employment income, PAYE and NIC and any state retirement pension.

From April 2018, it is intended that interest paid by banks and building societies will be included in digital tax accounts. In order for this to happen, banks and building societies will be required to provide information to HMRC earlier, and more frequently, than currently. Taxpayers will also be able to report any additional sources of income through their digital tax accounts in 2018.

Does an employer have to do anything?

Employers will see an increase in the number of tax codes being issued during the tax year but the way they are received does not change. The revised tax codes need to be applied before the next payroll is run. There is a brief employer information pack available at: **https://goo.gl/P74Gyt**.

The pack includes an employee section and, if you are an employer, you can direct employees to this guide. It explains to an employee the benefits of using their Personal Tax Account and how to access it.

Hackers' favourite sport – phishing

In early 2017, a UK company warned its employees about suspicious emails and how to deal with them. Two months later it sent a bogus email from the HR manager to a sample of employees requesting personal details. Despite the previous warnings, 54% of the employees clicked the link in the email and amazingly nearly all of those submitted data in the form provided via the link.

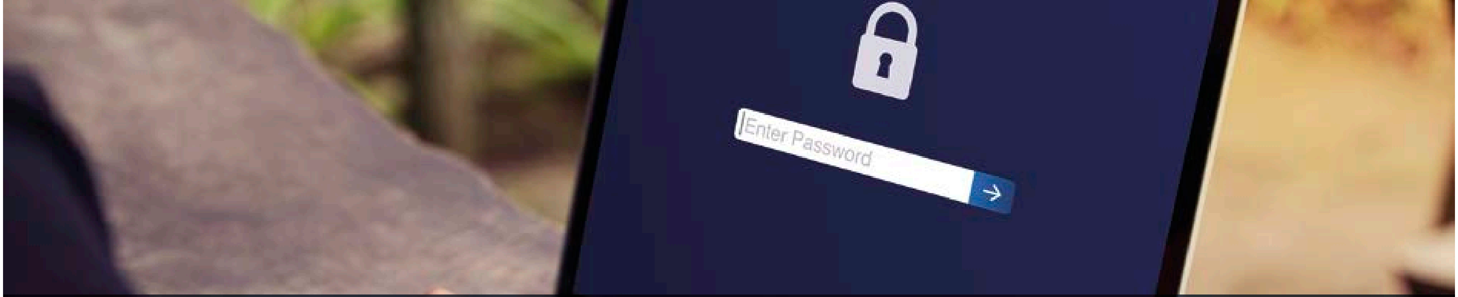
It is no surprise that the vast majority of hacking attacks begin with a phishing email. It may also be no surprise to know that HMRC is one of the most phished brands in the UK. What is more, there may be another surge as HMRC are encouraging individuals and businesses to sign up to their Personal Tax Account (PTA). The government's ambition is for everyone to have a PTA by 2020.

However, HMRC will never ask people to disclose personal or financial information by email. And that's the golden rule for any employee to remember for emails received from anyone.

Two links which you may find useful:

https://goo.gl/oJsCsr - this is a list of digital and other contacts from HMRC if you have any doubts about the authenticity of an email. It gives some helpful pointers to look out for if you are in any doubt as to whether an email or other contact that purports to be from HMRC is what it seems to be.

www.gov.uk/personal-tax-account - this is the page from which you sign up to a Personal Tax Account. The page lists what you can currently do in the Personal Tax Account, but the aim is for these to be secure areas where an individual or business can see all their tax details in one place and interact with HMRC digitally.



New data protection rules

There are new data protection rules in the pipeline, and they're likely to get a lot more publicity in the months to come. The new initials to look out for are GDPR.

GDPR - General Data Protection Regulation – is set to kick in from 25 May 2018. It increases the obligations on all businesses to safeguard the personal information of individuals which is stored by the business – be they customers, suppliers or employees. Broadly speaking, if you are already subject to the Data Protection Act, you're likely to have to comply with the GDPR.

GDPR will apply to data 'controllers' and 'processors.' Processing is about the more technical end of operations, like storing, retrieving and erasing data, whilst controlling data involves its manipulation in terms of interpretation, or decision making based on the data. The data processor processes personal data on behalf of a data controller. Obligations for processors are a new requirement under the GDPR.

New features

The GDPR applies to personal data – but the new definition is wider than under the Data Protection Act (DPA).

One key new feature is having to show how you comply with the rules. Evidencing compliance is known as the 'accountability' principle. Things like staff training and reviewing your HR policies are examples of compliance – and you'll need evidence to prove you've done it.

Under GDPR, higher standards are set for consent. Consent means offering people genuine choice and control over how you use their data.

Under 250 employees?

The legislation acknowledges that micro, small and medium enterprises have particular needs, and for record-keeping, the GDPR distinguishes between what is expected of organisations with more than 250 employees, and those below this size. There is a little more lee-way at the smaller end of the scale and additional requirements for organisations with 250+ employees.

250+ employee organisations have to keep internal records of processing activities, whilst smaller organisations don't. Smaller organisations however, do have to keep records of activities concerning higher risk processing. Higher risk processing is a category including processing of special categories of data or criminal convictions or offences, or personal data potentially impacting the rights and freedoms of an individual.

Showing compliance and consent

Overall, the aims of GDPR are to create a minimal data security risk environment, and to protect personal data to rigorous standards. For most organisations, this will entail time and energy getting up to speed with compliance procedures. Reviewing consent mechanisms already in place is likely to be a key priority. In practice, this means things like ensuring active opt-in, rather than offering pre-ticked opt-in boxes, which become invalid under the new rules.

Organisations will also have to think about existing DPA consents. The ICO's advice is that 'you will need to be confident that your consent requests already meet the GDPR standard and that consents are properly documented. You will also need to put in place compliant mechanisms for individuals to withdraw their consent easily.' If consents already in place don't meet the new standards, action will be needed.

Getting it wrong

As well as adverse reputational impact, the cost of getting it wrong could be high. Infringing the basic principles for processing personal data, including the conditions for consent, could mount to 20 million euros or 4% of total worldwide annual turnover (if higher).

This article highlights just some of the main features of the new rules. The Information Commissioner's Office (ICO) has published some very useful information and planning points to help organisations get ready ahead of the May 2018 deadline which are well worth reading **https://goo.gl/sBV45D** and **https://goo.gl/NwTzDY**

New ways to raise business finance - peer to peer lending

SMEs looking to raise finance have traditionally been tied to bank funding, but recently there have been significant changes.

Peer to peer (P2P) business lending is one new way of raising finance. It can be a direct alternative to a bank loan, and currently over 35,000 UK businesses have P2P loans, according to data published by the P2P Finance Association. Typically investors lend small parts of individual loans, with the online system making it easy for lenders to participate across multiple loans. Borrowers can access loans ranging from a few thousand pounds up to several million.

P2P lending platforms require online applications, each with its own qualifying criteria. Borrowers usually need a trading track record and would have to submit financial accounts. Whilst interest rates may be higher than bank finance, P2P can have the edge in terms of speedy decision-making.

There are safeguards and guidelines: the Financial Conduct Authority (FCA) regulates P2P. P2P loans can be held in a new Individual Savings Account – the 'Innovative Finance ISA' possibly making P2P even more attractive to lenders. Information on P2P lending and links to lenders is available at **http://p2pfa.info**

50 Osmaston Road
Derby DE1 2HU
Tel: 01332 345265

The Old Manse
29 St Mary Street Ilkeston
Derbyshire DE7 8AB
Tel: 0115 932 3995

3 Derby Road Ripley
Derbyshire DE5 3EA
Tel: 01773 743325

E-mail: derby@mabeallen.co.uk
Website: www.mabeallen.co.uk

Mabe Allen LLP
Chartered Accountants &
Business Advisers

J.P. Allen, FCA, FCCA, MABRP
K.C.G. Slack, FCA, FCCA
B. Sutton, FCA, CTA
C.J. Hopkinson, FCA, FCCA
D.J. Allen, BA (Hons), FCA, FCCA

Registered Auditors

Mabe Allen LLP is a Limited Liability Partnership registered in England and Wales.

Partnership Number: OC 308775

Registered Office: 50 Osmaston Road, Derby DE1 2HU

Corporation Tax – special rules for companies

When Corporation Tax was invented in 1965, the quantification of taxable profits bore a close resemblance to the taxation of the unincorporated business for many years. In more recent times the determination of profits has moved substantially from the original similarity and special rules have been introduced.

In this Briefing we review some of the special rules for companies.

Reliefs for trading losses

Loss reliefs seem to be an unusual place to start as companies are expected to make profits aren't they? However new reliefs are proposed (in autumn Finance Bill) for companies with losses arising from 1 April 2017, so this is why we are starting here. Also it is common for companies to generate losses through set up expenditure on new trades and/or additional investment in plant and machinery which provides an immediate tax write off with £200,000 of Annual Investment Allowance being available.

The loss reliefs available to companies are fairly generous if the company (or other companies in the same qualifying group of companies) have profits arising in the same accounting period in which the loss arises. Trading losses can be set against the company's profits of the period in which the loss arose, or surrendered as group relief in the same period.

A trading loss can be carried back against total profits of the previous 12 months. However, losses carried forward to a later period are more restricted.

Losses arising before 1 April 2017 can only be set against later profits of the same trade. Carried-forward amounts cannot be surrendered as group relief.

Losses arising from 1 April 2017, when carried forward, are given more flexibility and will be available for set-off against the total taxable profits of a company and its group members.

There is a potential sting in the tail for larger companies. From 1 April 2017, the new rules limit the amount of profit against which all carried-forward losses can be set to a maximum of 50% of the company's total profits for the period. However, each group, or a company that is not part of a group, will have an annual allowance of £5 million profits. Carried-forward losses can be set against that amount without restriction. The 50% restriction only applies to profits above the £5 million annual allowance.

Example

A company has the following expected results for the year to 31 March 2019 - trading profits £40,000 and property income £30,000. There is a trading loss brought forward of £60,000.

If this loss had been incurred pre 1 April 2017, only £40,000 would be capable of relief in 2019 against the trading profit and £20,000 would have to continue to be carried forward. If the trading loss has arisen post 1 April 2017, all of the loss can be relieved against profits in 2019.

Loan relationships

In the 1990s a trend developed to legislate specifically for the taxation of corporate profits. One area was the taxation of corporate debt. A loan made by a company to another entity or a loan granted to a company by a bank are examples of what are termed 'loan relationships'. The loan relationship regime removed the distinction between income and capital treatment for transactions involving debt. This is in marked contrast to the system that still applies to unincorporated businesses. Interest receipts and payments in such businesses are taxed as income or relieved against income. A loss made on a loan which is not repaid is however a 'capital' matter. Whether the loss gets any relief is a matter for the capital gains tax legislation.

The basic rules for loan relationships for companies are that:

- the tax system potentially recognises all debits and credits that arise from borrowing and lending
- the debits and credits will generally follow the accounting entries made for the purpose of the financial accounts

- trading items are dealt with as trading receipts or deductions
- non-trading items are taxed as net income from non-trading loan relationships with special rules for the relief of net non-trading deficits.

An example of a trading item for a company is a loan from a bank to provide finance for investment in plant to be used in the company's trade. If a company provides a loan to another company to help finance the other company's trade, this is likely to be a non-trading item.

Example

Co A lent to Co B £100,000 at an annual interest charge of £8,000 some years ago. Co A was keen to develop a relationship with Co B and has a minority stake in Co B. Co A typically makes annual profits of £80,000.

In previous years the corporation tax treatment would have followed the entries in the annual accounts, namely:

Co B - interest payable £8,000 – treated for tax as a trading expense.

Co A - interest receivable £8,000 – treated for tax as non-trading income.

In the current year, Co B has got into significant financial difficulties and is unable to pay the interest. Co A makes a full provision against the interest receivable and a £70,000 impairment of the loan.

Co B will accrue for the interest payable of £8,000 – which will be treated for tax as a trading expense as in earlier years.

Co A has no net income recognised in the accounts for the interest due to it and thus there will be no income for tax purposes. There will be a non-trading deficit of £70,000 in respect of the loan. This will be set off against the trading profits in that year.

One can see that this system does simplify the taxation of companies. However, over the years, the system has been complicated by legislation counteracting scenarios in which governments have perceived that the regime has been too generous in allowing relief for losses made on loans.

Two examples in which special rules may be applicable to small and medium sized businesses are:

- If a loan is made between connected companies tax relief for the writing down of a loan is generally not allowed. 'Connection' in this scenario means control of one company by another, or where both companies are under common control. Companies in a group are therefore connected as are two companies controlled by the same individual. So in the example above, Co A would not get relief for the £70,000 impairment.
- If a loan is made by a 'close' company (a company with five or fewer shareholders) to one of the shareholders and the company writes down the loan, specific legislation denies relief to the company in this instance.

Intangible assets

The taxation of intangible assets represents another area where the taxation treatment for companies moved away from a regime which still applies to unincorporated businesses. Intangible assets include such items as goodwill, trademarks and patents. Much of the expenditure on the acquisition of such items by businesses would represent capital expenditure and thus would not be deductible from trading income. Capital allowances were given for some items, for example patents, but other items, such as goodwill, were dealt with under the capital gains tax rules.

A company's acquisition of intangible assets from 1 April 2002 or created by the company from this date, is dealt with under one regime. In common with the principles of the loan relationship rules, taxable debits and credits follow the accounting entries made for the purpose of the financial accounts. Relief will be given for intangible fixed assets as the assets are written off (amortised) against profits.

Goodwill

Goodwill is one of the more common types of intangible expenditure by a company and may arise when a company acquires another business. In simple terms it is the difference between the purchase price of a business and the value of the tangible assets purchased and any other intangible assets. If a company has purchased the shares rather than the assets of another company, there will be no relief for the goodwill purchased as that is only reflected in the consolidated accounts of a group of companies and not in the accounts of the company which has purchased the shares of another company.

For purchases of goodwill before 8 July 2015, relief for the goodwill purchased was given when, and to the extent that, the goodwill was charged against profits. As the acquired business assets were likely to be used for the purpose of the company's trade, the amortisation reduced the trading profits of the company. If the company sells on the business in the future, the accounting profit will be taxed as trading income.

What about intangible assets acquired from 8 July 2015?

From 8 July 2015, a company acquiring a business is no longer able to claim a tax deduction until the goodwill is sold. If the goodwill is sold at a profit, this is generally taxed as trading income.

What about intangible assets acquired or created before 1 April 2002?

If a company acquired such assets before 1 April 2002, the assets remained outside the regime. The main practical effect of this rule, now that we are 15 years on from this date, is that if a company started a trade before 1 April 2002 and is now selling its trade, any amount(s) allocated to intangible assets will fall under the old taxation code (internally generated goodwill is deemed to have been created when the trade started). So, the sale of goodwill will fall to be taxed as a capital gain rather than trading profits.

Reinvestment relief

The intangible assets regime has a useful relief – called reinvestment relief – which can be used where the proceeds from the sale of an intangible asset are reinvested in a new intangible asset or assets. The relief is available where the proceeds on the sale of the old asset exceed the initial cost of that asset. The surplus is deducted from the acquisition cost of the new intangible assets. Thus there is no immediate tax charge on the element of the gain that is reinvested, but the result is that the sum available for future amortisation on the new asset is reduced. The expenditure on the replacement intangible assets has to be capitalised in the accounts.

The relief works in a similar way to a relief available on the sale of certain tangible capital assets of a company – called rollover relief. An example of a relevant tangible asset is freehold land. The gain which would otherwise be taxed as a capital gain can be rolled over against the acquisition cost of any other asset within the rollover relief regime.

What is not allowed is the deferral of corporation tax by reinvesting proceeds from the sale of an intangible asset into tangible assets and vice versa. They are two separate regimes.

How we can help

As can be seen from this summary, the corporation tax code is potentially complex. Please do contact us if you are considering significant transactions involving any of the above areas.

50 Osmaston Road
Derby DE1 2HU
Tel: 01332 345265

The Old Manse
29 St Mary Street Ilkeston
Derbyshire DE7 8AB
Tel: 0115 932 3995

3 Derby Road Ripley
Derbyshire DE5 3EA
Tel: 01773 743325

E-mail: derby@mabeallen.co.uk
Website: www.mabeallen.co.uk

Mabe Allen LLP
Chartered Accountants & Business Advisers

J.P. Allen, FCA, FCCA, MABRP
K.C.G. Slack, FCA, FCCA
B. Sutton, FCA, CTA
C.J. Hopkinson, FCA, FCCA
D.J. Allen, BA (Hons), FCA, FCCA

Registered Auditors

Mabe Allen LLP is a Limited Liability Partnership registered in England and Wales.

Partnership Number: OC 308775

Registered Office: 50 Osmaston Road, Derby DE1 2HU

Passing on the family business

Many people running their own business cherish the thought of some members of their family continuing to run their business when it comes time to retire. The business that you have grown and developed in your lifetime can continue to do so in family hands rather than being sold to another business which may absorb your customers into its products and services. And is it a type of business that, despite being profitable, can be sold anyway?

In this Briefing we take a look at the key issues to keep in mind in order to enhance the prospects of a family succession taking place. We concentrate on the tax issues for yourself and other members of the family.

Are you currently trading as a company?

A business can be set up in several different forms - sole trader, partnership, limited liability partnership, or company. In general terms, running a business as a company can be beneficial for succession planning because:

- many more combinations of ownership are possible - family members can gradually be given an increased percentage stake in the business
- different rights can be given to different types of share, which may make planning more flexible
- shares can allow someone an interest in the ownership of the company without them having direct involvement in the management of the business.

In the rest of this Briefing we focus on the issues appropriate if trading as a company.

Is family succession the best for your family and your business?

In the early days of planning for family succession, the answer is likely to be, 'we don't know if this is the best route for the family'. The children may have just finished their education and may be unsure about their career choices. You may not have a clear idea as to their capabilities. The answer is to test the willingness of members of the family to be involved in the business by giving them an opportunity to be involved in many aspects of the business over time, such as the production process, human resource issues, managing cash flow, sales and marketing. Working in other businesses may be a better way for them to gain experience and broaden their business education.

You need to consider an appropriate time for them to obtain some equity in the business. Having a shareholding will encourage them to help you develop the business. It is in this scenario that running a business as a company often offers significant advantages over operating as a partnership. A clear division can be made between the amount and type of the equity stake and the management responsibilities of the family member.

In tax terms, the gift of shares to family members who work in the business may be easier than share issues to other employees. If an employee receives shares in the company and does not pay full value for them, there will be an income tax charge on the amount of the undervalue. There is an exception from an income tax charge if the right to shares 'is made available in the normal course of domestic, family or personal relationships of that person'. HMRC state in their manuals that they 'take a common-sense view of this exception' and we can help you decide if the exception applies.

Consideration also needs to be given to non-working members of the family. Should they receive some shares (perhaps of a different class to the shares received by the working members) or would it be better for them to receive a larger part of any eventual inheritance? In tax terms, the gift of shares is straightforward. They are not employees and so there is no immediate tax effect on them.

The gift of all these shares will be disposals for capital gains tax (CGT) purposes by you but gift hold-over relief should be available if the company's main activities are in trading rather than non-trading activities such as property investment.

Tax planning for the actual succession

Most often, you (and perhaps your spouse) will retain a controlling interest in the company until retirement. The equity stakes of the younger generation may have been gradually increased over the years.

How the business is handed over to the next generation will, in part, be a financial issue. Will you and your spouse require continuing income from the company or capital funds to enable a comfortable retirement?

If there is a need for funds in retirement, one possibility is for control to be given up to other family members but with some shares (perhaps with preferential rights to dividends) retained to provide an income stream in retirement. These dividends will, of course, be subject to income tax. There will be non-tax issues to consider here. What will be the attitude of the sons and daughters now running the business about the continuing need to pay the first slice of profits to the parents? This could give rise to tensions within the family.

A cleaner break and more tax efficient route would be to extract funds from the company in one go or over a short period of time in a form which would be taxed at CGT rates rather than income tax rates.

Extracting funds tax efficiently - can you get capital receipts from the company?

Although our tax system does change with different governments, there has been a fairly consistent theme to how taxes impact on the owner of a corporate business. Income tax rates are generally higher than rates of CGT. The rate of income tax depends upon the amount paid and the detail of the taxation regime for dividends. If a shareholder could have a capital return from the company and have the gain subject to CGT, the rate of CGT can be substantially lower particularly if Entrepreneurs' Relief (ER) is available. Gains up to £10 million are eligible for ER at a 10% rate. Of course, this rate and amount of gains which qualify may not be this figure when you come to retire but most governments have favoured a low tax rate on certain capital gains made on disposal of business assets owned by individuals running the business.

The tax system is however alive to the preference of the shareholder for capital receipts. The tax system defaults to taxing returns to shareholders as income even if, under company law, the nature of the return is classified as a capital transaction. There are two main exceptions:

- If a company is formally liquidated – the return of remaining funds to the shareholders will be potentially subject to CGT rather than income tax
- If the company buys back shareholdings of an individual withdrawing from involvement in the business – a qualifying 'purchase of own shares'.

Under the first option, due to anti-avoidance legislation, the shareholder may not get CGT treatment if the business continues to be carried on by the current shareholders or individuals connected with them and it is reasonable to assume that one of the main purposes of the winding up is the reduction of a charge to income tax.

It is the second option which can be very attractive to the older generation making way for the next generation to run the business.

What is a qualifying 'purchase of own shares'?

A qualifying 'purchase of own shares' provides a mechanism of extracting cash from the company in a tax efficient manner and leaves the company in the hands of the next generation.

A number of conditions need to be satisfied and there are arithmetical tests to determine whether sufficient shares have been purchased by the company. The main thrust of the requirements is that an individual (and their spouse) must sever most of their connections with the company in terms of shareholdings and working in the business.

Clearance from HMRC is available prior to the purchase, that capital treatment of the cash receipts by the shareholders will be available. In addition, the conditions for obtaining ER will need to be satisfied in order to only pay 10% CGT. Three basic conditions have to be satisfied in order for a gain on shares to qualify for ER in the 12 months leading up to the date of share purchase:

- the company must be a trading company (with any non-trading activities being 'insubstantial')
- the shareholder must have held at least 5% of the voting rights and ordinary shares
- the shareholder must have been an officer or employee of the company (not necessarily on a full time basis).

The example below illustrates how the purchase of own shares can work.

Example

Mr and Mrs Davies have 70% of the ordinary share capital of a trading company. In recent years two of their children, who are now directors of the company, have been given 30% of the shares. Mr and Mrs Davies want to retire and leave their two children in control.

Both Mr and Mrs Davies have been directors of the company and will remain so until the purchase of own shares is effected.

They would like most of the profits which have been accumulated in the company as payment for their shares.

The company will purchase the shares of the couple. A very useful effect under company law is that the company will cancel the shares on purchase. This will mean that the children, from previously owning 30% of the company, now own 100% of the company.

Mr and Mrs Davies will make a capital gain to the extent that the proceeds exceed the amount they originally paid for the shares. The company and the shareholders have ensured that the qualifying conditions for ER have been met in the 12 months leading up to the share purchase.

In addition to the tax rules, there are many company law procedures to follow which we can, of course, advise you on.

How the share purchase is financed by the company, can also give rise to issues. Financing is not helped by the taxation requirement that the shareholders cannot be 'connected' to the company after the share purchase. This means most of the shares need to be purchased at the same time. The cash cannot be left outstanding as this would be treated as loans to Mr and Mrs Davies and loans fall into the determination of whether the shareholders are connected to the company after the purchase of own shares. However there are ways we can advise upon which can steer around these issues.

How we can help

In this Briefing we have only been able to outline some issues that should be considered for your family business. 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 whatever you decide to do, HMRC will not be the biggest beneficiary.