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Exit ahead - tax planning for the owner managed business

As a business owner, if you have not already given some thought as to how you would like to exit your business, then you will need to do so at some time in the future. The principal options will be to either sell your business to a third party or to sell, gift or leave it to your family. Whatever option you choose there are two very valuable capital tax reliefs that may come into play and both reliefs exist to reduce your overall capital taxation liabilities. This briefing gives an overview of the two reliefs and concentrates on some of the key pitfalls to avoid.

Whilst both reliefs set out to reduce the overall tax burden, there are a number of differences as regards the qualifying conditions for the reliefs to apply. Capital gains tax Entrepreneurs' Relief (ER) and inheritance tax Business Property Relief (BPR) are available to individuals holding shares in trading companies as well as those who have an unincorporated business. ER can reduce your effective rate of capital gains tax from up to 28% to 10% and each individual has a lifetime allowance of £10m. Individually this means that the maximum overall tax saving for ER purposes could be £1.8m! BPR may result in up to 100% relief which reduces your effective rate of inheritance tax from 40% to 0% and no upper limit applies to BPR unlike ER.

Qualifying business disposals for ER

As a brief recap, three types of disposal will potentially qualify for ER:

- a material disposal of business assets
- a disposal associated with a relevant material disposal
- a disposal of trust business assets.

Each type has specific conditions and relief is available only for what are termed relevant business assets. The disposal of trust business assets is outside the scope of this briefing.

As regards the first point a disposal of business assets may arise where there is a disposal of:

- the whole or part of a business
- a disposal of business assets following business cessation and
- a disposal of shares in or securities of a company.

In each case different conditions apply to turn the disposal into a material disposal for ER. In general terms the individual must have owned the business or shares throughout the period of a year ending with the date of disposal and assets must have been in use for the purpose of the business.

What is a business for ER and BPR?

So what exactly do we mean by a business? Well firstly in general terms anything which is a trade, profession or vocation and which is carried on commercially is a business for ER purposes. The key point is that the business must be trading in order to qualify for ER.

If you own shares in a company, in order for the shares to qualify for ER on a disposal or a transfer, the company must be a trading company. In practice it is possible that there may be some non trading activities, for example the company also generates some investment income. If this is the case how does this fit in with the rules? Where non trading activities are carried on, these must not be substantial for which a 20% or more threshold is generally used.

The test for BPR purposes under inheritance tax is different in that the business must not be wholly or mainly one of making or holding investments. In practical terms this means that the trading activities must be over 50% of the total activities. In addition dealing in securities, stocks or shares, land or buildings is specifically excluded for BPR purposes even though dealing activities would normally be considered to be a trading activity.



So how should a company's non trading activities be measured to assess whether they are substantial for ER and BPR purposes? HMRC guidance is limited but includes examples where:

- a company has a trade but also lets an investment property. If the company's receipts from the letting are substantial in comparison to its combined trading and letting receipts, then on this measure in isolation, the company would probably not be a trading company
- if the value of a company's non trading assets is substantial in comparison with its total assets then this could point towards it not being a trading company
- if a substantial proportion of the expenses of a company are incurred on non trading activities then the company would probably not be a trading company
- the company devotes a substantial amount of its staff resources, by time or costs, to non trading activities.

In reality any proper decision should be made by considering a combination of factors not any isolated factor.

Sole traders and partnerships

The reliefs apply equally to an unincorporated business where there is a disposal of the business or an interest in it. For ER purposes there is a clear distinction between disposal of a trade or part of a trade as opposed to disposing of just an asset used for the purposes of a trade, which in isolation will not qualify for ER. For BPR purposes, a single business asset transfer may qualify for BPR as well as the gift of a trading business or interest in it.

Individual requirements for shareholders

For ER purposes the relief will apply to disposals of shares where for at least 12 months up to the date of sale or transfer both of the following conditions are met:

- the individual owns at least 5% of the ordinary share capital which enables them to exercise at least 5% of the voting rights in that company. This makes the company their personal company within the rules
- the individual is an officer or an employee of the company (note that this does not have to be on a full time basis).

As long as the individual has owned at least 5% of the shares for 12 months any additional shares acquired prior to disposal will also qualify for relief. Shareholdings in a quoted company also qualify for ER as long as the above conditions are met.

For BPR purposes there are no restrictions relating to the type of shares that will qualify and there is no requirement that the individual has to work in the business. Additionally, no minimum shareholding percentage is required. Shares in quoted companies will also qualify but only for controlling holdings and then relief is only given at a rate of 50%. Generally, shares must be held for two years although there are special rules allowing an earlier period to be counted, for example, where the assets are inherited from a spouse or civil partner.

Assets held outside the business

It is quite common for certain assets such as commercial property to be retained outside of the business. In these cases ER may be available on certain assets which are used for the purposes of a trade, business or vocation carried on by the individual in partnership or by a company of which the individual is a shareholder.



This will apply where the disposal of the asset is associated with (ie linked with) a relevant material disposal. This means that three conditions have to be satisfied:

- the individual makes a material disposal of either the whole or part of their interest in the assets of a partnership, or the shares in a company
- the associated disposal is made as part of the withdrawal of the individual from the partnership or the company and
- the assets are in use in the business throughout the period of one year ending with the earlier date of the material disposal of business assets or the cessation of the partnership or company business.

Be warned though that ER will not be available on the disposal of the asset in isolation.

Furthermore, a qualifying associated disposal of the asset may have the ER restricted to take account of specific circumstances relevant to the whole period of ownership of the asset by the individual. Where, for example, a property has been held personally outside the business and rented to the company or a partnership a restriction is made where rent is charged for periods after 6 April 2008.

BPR is available but only at a rate of 50% where the asset is used wholly or mainly for the purposes of a business carried on by a company where you have a controlling interest or by a partnership where you are a partner. One key difference is that the transfer of the asset does not have to be associated with a disposal of the underlying business or shares at the same time.

Other restrictions

BPR can be further restricted in relation to assets which have not been used wholly or mainly for the purposes of the company's business and which are not required for future business use, for example cash balances built up within the company for which no future business purposes are identified can be a problem area.

Summary

As can be seen the rules are somewhat complex and contain some pitfalls for the unwary seeking to take advantage of these very generous reliefs. Please do contact us for advice specific to your circumstances before carrying out transactions of this nature.