



## Tax advice for business-owners

### Two ways to make money

As all business-owners know, there are two ways in which to make money from a business. The most obvious way involves the day-to-day profit-making activities of the business.

The other way to make money from a business is to sell the business itself!

In many cases, it is the sale of the business itself which makes the most money for its owner. Despite this, many owners spend so much time working in their business that they pay too little attention to working at their business. This is where Exit Planning comes in.

### What is Exit Planning?

Exit Planning is about far more than simply selling a business. In the sense it is used here, Exit Planning means considering the business structure throughout its life - with a view to maximising the return if and when an exit happens.

Obtaining proper tax-advice is one of the main features (although far from the only one) of Exit Planning. As such, this briefing note is designed to look mainly at tax aspects of Exit Planning. It does not attempt to give a comprehensive guide to all tax issues. Instead it attempts to highlight some of the main tax-considerations which will be relevant to businesses throughout their lifetimes.

### The outset of a business

- Ideally, advice on the structure of a business should be obtained right from its inception in order to maximise the possible returns on an ultimate exit!
- The first question will usually be whether or not to operate the business through a company or as a sole trader/partner. Since 2000 it has also been possible to establish a limited liability partnership (LLP).
- Despite the abolition of the zero percent corporation tax rate on the first £10,000 of profits, the tax position may

still make it advantageous to set up a company. However, this requires a careful calculation in each case. We have produced an interactive spreadsheet which can provide a quick answer to this question.

- If losses are anticipated in the early years, however, operating as a sole-trader/partner may be preferable.
- Choosing a company may affect the ultimate exit strategy. If a corporate purchaser wishes to purchase the business of the company (rather than the shares in it) then the tax on exit may be as high as 54% (compared to a possible 10% if shares are sold).
- One possible strategy involves creating a limited liability partnership with a company as one of the partners. This should enable profits to be extracted in the most efficient way.
- Establishing a partnership between husband and wife, or having both spouses owning shares in a company may be worth considering now that the Court of Appeal has ruled in the taxpayers favour in the *Jones v Garnett* case. However, there is still the danger of new legislation in this area to reduce the tax benefits available.
- Where the provisions of the Enterprise Investment Scheme (EIS) may apply, this offers the possibility of Capital Gains Tax (CGT) exemption after 3 years.
- If one spouse is not domiciled in the UK, a range of additional possibilities open up.

### International aspects

- For businesses with international operations careful thought has to be given to their structure.
- An important question at the outset of international operations will be whether to operate as a branch or through a subsidiary company. The generally accepted wisdom is to start life as a branch (when early-year losses will be relieved in the UK) and to move to subsidiary status once profit-making. The relative tax-

rates in each country may affect this general advice, however, as may the ability to offset foreign losses against profits of the UK parent.

- Careful advice needs to be taken as to the tax-efficient repatriation of profits. Tax-treatment may differ between interest, dividends and royalties. Some countries have rules (thin-capitalisation) which recharacterise excessive interest payments as dividends.
- A double-tax treaty may exist between the two countries. Advice needs to be taken both in the UK and in the foreign jurisdiction.

### **Extracting value from companies**

- Where no other exit is immediately in prospect, business-owners may wish to consider how to extract value from their companies.
- Careful thought needs to be given as to whether to pay dividends or salaries. The former are generally taxed at up to 36% but the company receives no deduction for corporation tax purposes. The latter may be taxed at up to 50% but the company will usually obtain a deduction.
- Increasing rates of National Insurance Contributions (NICs) both for employers and employees may again favour a dividend.
- In some situations it may be possible to extract value with a tax rate of only 10%, but this requires careful planning and (usually) some restructuring of the company.
- Despite a number of changes to their taxation, Employee Benefit Trusts (EBTs) and Employer Financed Retirement Benefit Schemes (EFRBS) still offer significant tax planning and practical opportunities.

### **Reconstructions and demergers**

- As noted above, reconstructions of companies may enable profits to be extracted at a tax-rate of only 10% in some situations.
- In other situations, company structures may have grown "organically" with too little thought being paid to the ultimate exit. In some cases, the structure may prevent valuable CGT and Inheritance Tax (IHT) reliefs from applying. Where this is the case, careful thought should be given to a reconstruction or demerger of the business.
- Reconstructions may also be required to put a business into an appropriate form to enable part of it to be sold. Such planning should be undertaken well in advance of any prospective sale to avoid tax problems.
- Reconstructions and demergers generally require a number of different tax-clearances to be obtained.

### **Incentivising employees**

- Offering equity-participation to employees involves far more than a question about the employees' salary-packages.
- The use of share schemes and Employee Benefit Trusts (EBTs) may enable a business to retain key staff and gives those staff an incentive to grow the value of that business.
- In addition, an EBT may be able to act as an internal-market for otherwise unquoted companies.
- Individual employers who wish on their death to leave gifts to employees need to consider the terms of their Wills carefully. Unless well drafted, employees may end up with an income tax charge on such gifts.
- Employee share schemes may be a means towards an ultimate management buy-out. In any event, they can often help to prepare a business for an ultimate sale.
- EBTs and share schemes (both Revenue approved and unapproved) offer significant tax-advantages to employees and, in some circumstances, to the existing owners of a business.
- While it is always preferable to plan employee incentives as early as possible, our pr-EMI-um solution can enable value to be passed to employees much closer to an exit event.

### **Shareholder/Partner cross-assurance**

- Where a business is owned by unrelated individuals, it is often sensible to provide a mechanism on the death of one shareholder for the other shareholders to buy-out his or her shares. The same applies to partnerships.
- Life assurance will often be taken out in conjunction with these arrangements to enable the remaining shareholders to finance the purchase.
- Very careful planning has to be undertaken in such situations as unexpected tax consequences can easily emerge.
- It is normal for policies to be taken out on each shareholder's own life but to be written in-trust for the other shareholders.
- If there is a binding contract for the remaining shareholders to buy the shares (or for the deceased shareholder's estate to sell) then valuable inheritance tax reliefs are lost. It is therefore usual to structure the arrangements as cross-options (where one party has an option to sell and the other an option to buy).
- An alternative is for the company to take out the assurance and have an option to repurchase the shares in question. Company law questions (concerning financial assistance and distributable reserves) may need to be addressed.

- Where the company funds the premiums, it may not wish to claim these as a corporation tax deduction. If it does so, it will be taxed to corporation tax on the receipt of the proceeds.
- Where the company funds the premiums for shareholders to take out their own assurance, there is an annual benefit in kind - chargeable to income tax and NICs.

### Entrepreneur's relief audits

- Entrepreneur's relief for CGT purposes offers the prospect of a 10% rate of CGT after just 12 months ownership on up to £2m of capital gain.
- However, many business-owners mistakenly assume that the 10% rate of tax will automatically be available. This can often be fatal as there are a large number of circumstances in which this will not be the case.
- All business-owners should obtain advice regarding entrepreneur's relief at least a year before they plan to sell their businesses.

### Tax planning for the sale

- As a sale draws nearer, the opportunities for last-minute tax planning become more limited. However, a number of possibilities remain open.
- Those worried about increasing CGT rates might look at 'uncompleted contracts' to lock into existing CGT rates.
- Non-residence may still give total CGT exemption.
- If an owner is planning to make gifts to charity, he or she may be better advised to give shares to the charity (who can then join in the sale) rather than giving out of the proceeds of the sale. The purchaser's attitude to this needs to be watched carefully, however.
- Post-sale tax planning opportunities are limited. Investment in VCT/EIS companies may defer any capital gain.

### Passing the business on to the next generation

- Many business owners wish to pass their businesses on to the next generation, but are keen to do so gradually over a period of time. Particular tax issues may arise in this context.
- Where a business is being passed on to one child (in preference to others) thought must be given to how the structure can also offer some benefits to the other children.
- Difficulties can arise where an owner wishes to continue to draw a salary, having given away some or all of his shares. Split-share schemes may help in this situation.
- Inheritance tax reliefs will often avoid IHT on the gift of business assets. Where they are not available, thought has to be given to other structures. This may again involve creating different classes of shares with deferred rights.
- The use of trusts, particularly where the previous owner remains as one of the trustees, enable a transition to be properly managed while retaining tax advantages.
- As ever, business-owners should pay particular attention to their Wills.

For further information please contact:



**John Barnett**

Tel: +44(0)117 902 2753  
john.barnett@burges-salmon.com