william duncan + co
Chartered Accountants
& Business Advisers

Ellersley House, 30 Miller Road, Ayr Tel: 01292 265071
75 Glaisnock Street, Cumnock, Ayrshire Tel: 01290 420333
2nd Floor, 18 Bothwell Street, Glasgow Tel: 0141 535 3133
4D Auchingramont Road, Hamilton Tel: 01698 283103
44 Bank Street, Kilmarnock Tel: 01563 626000
Loch Awe House, Barmore Road, Tarbert Tel: 01880 820277

williamduncan.co.uk

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.