Business Tax Briefing

Planning For A Sale

Despite the fragile state of the UK economy, clients frequently ask us to advise on the sale of their businesses. Buyers therefore still exist for sound businesses, although the sale process can often be lengthy as cautious buyers will carefully assess their target before committing to buy. Furthermore, due to the currently prevailing high marginal tax rates, tax planning continues to be a critical factor in any sale process as buyers and sellers seek to squeeze out every possible benefit from their transaction.

This Business Tax Briefing therefore focuses on four key areas that a business owner should consider when planning for the sale of his or her business.

The first article considers how a company can use innovative and tax efficient share schemes to attract, motivate and retain employees who will have a key role in building up the business prior to an exit.

The second article looks at the specific problem facing key employee shareholders who hold a stake of less than 5% in the company, and do not therefore qualify for the valuable Entrepreneurs' Relief which provides a 10% rate of capital gains tax upon sale. The article provides some potential solutions to this thorny issue.

Our third article reviews the preparatory work which should be carried out in advance of selling the business to ensure the owner has the best possible chance of attracting a purchaser and maximising the sale price.

The final article covers an alternative way to exit a business where it is proving difficult to find a purchaser, or where the management team does not have the resources to buy out a retiring business owner.

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1 Using Share Incentive Schemes To Reward Key Employees

Many companies use share incentives as a way to attract, retain and motivate key employees, and this is supported by the Government via their tax advantaged Government approved share and share option schemes such as the Enterprise Management Incentive ("EMI") scheme.

Under the EMI scheme, employees are issued with options to buy shares in their employer company in the future. Provided the acquisition price is equal to the market value of those shares at the date the option is granted, there is no income tax charge on the difference between the market value on acquisition and the amount paid (as there would be under normal rules).

However, Government approved schemes place restrictions on the types of companies that can use them, and the value of the shares which can qualify. For example, the EMI scheme is designed for small to medium-sized independent trading companies or groups (broadly a parent plus its 51% subsidiaries) with gross assets of less than £30 million and fewer than 250 full-time employees. There are also restrictions on the types of trade which qualify, and options can only be granted over fully paid up ordinary shares.

There is also a further problem with Government approved share schemes. Under the employment related securities rules, an employee who acquires shares will be subject to income tax on the difference between the amount they pay for the shares and their full market value. Therefore, whilst Government approved share schemes such as EMI options may be suitable for companies whose shares do not have significant value, they are less attractive where an employee has to pay a substantial amount for his shares.

Despite this, there are ways in which employers can provide cost effective shares without Government approval at a low tax cost to employees, even if the employer company already has significant value. One such strategy is to issue employees with partly paid shares (for example, an employee may be required to pay a nominal amount of £1 per share, with the balance payable at some future point). If correctly structured, the employee will not pay any tax on the outstanding balance, and will be subject to Capital Gains Tax ("CGT") rather than income tax on any future increase in value.

Another strategy is to issue employees with shares which only carry an entitlement to the future growth in value of the company. These shares will have a much lower value then the company's ordinary shares, meaning that the employee can pay much less for them.

Therefore, if you are looking for a tax efficient way to reward your employees, we would be happy to discuss possible solutions with you.

Finally, a key issue with share schemes is the valuation of the shares or options issued to employees, since this will impact on the amount of tax employees and employers will be required to pay. At Rawlinson & Hunter we can provide independent valuations of companies and shares, and negotiate with HMRC's specialist valuation division to achieve a favourable outcome for both employers and employees.

2 Maximising Entrepreneurs' Relief For Employee Shareholders

When Entrepreneurs' Relief ("ER") was introduced in the March 2008 Budget as the replacement for Business Asset Taper Relief ("BATR"), it seemed a very poor second. With a top CGT rate of only 18% for non-qualifying gains, and a lifetime limit of just £1,000,000, the maximum tax saving was a rather miserly £80,000 compared to the potentially unlimited savings under the BATR regime.

A few Budgets later and the story is more interesting. From 6 April 2011, the lifetime limit for qualifying gains has been increased to £10,000,000, so the potential tax saving when compared to a maximum CGT rate of 28% is a rather chunkier £1,800,000. This is now definitely worth claiming!

The problem is that fewer asset categories qualify for relief under ER than they did under BATR. In particular, one casualty of the ER regime is shareholdings under 5%.

Under BATR, any employee-owned shares in an unquoted trading company would have qualified for relief. The shareholder did not even need to be an employee of the company.

However, under ER the position is very different. In addition to the requirement for shareholders to be employees or directors of the company, they must also hold at least 5% of the nominal value of the issued share capital, and be able to exercise at least 5% of the votes. This means that many employees who would previously have qualified for BATR no longer qualify for any relief, and will therefore potentially pay CGT at 28% upon selling their shares.

So is there anything that can be done to improve the position of employees who are no longer entitled to CGT relief on their small shareholdings?

One option is to alter the share structure so that the employees meet the requirements for voting rights and nominal share value. This can often be achieved in a tax free manner by altering share rights. Then, provided they hold the shares for at least 12 months after the change in share structure,

the employees should qualify for ER upon a disposal of their shares.

Alternatively, where there are a number of shareholders who own less than 5% each but between them own at least 10% of the shares in total, they could combine their shares through a management company. Provided certain requirements are met, and subject to the minimum 12 month holding period, the shares should then qualify for ER.

If your senior employees do not currently qualify for ER on their shares in the company, we would be happy to speak further about ways in which their position can be improved.

3 Grooming A Company For Sale

Preparation is a very important part of the process of selling a company, and should ideally begin well before there is a prospective purchaser in the wings. How a company prepares for a sale can have a significant impact on the amount offered, and on the net "after tax" proceeds. A number of key issues to consider are set out below.

It is important to consider how a company will be viewed by a prospective purchaser, and to consider how to make the offering as attractive as possible. Sometimes, for reasons which were valid at the time, different businesses will have been established in separate companies, each with different shareholder groups and different combinations of individuals.

For a prospective purchaser, this is likely to cause difficulties should they intend to buy all of the companies, as it will tend to make negotiations more protracted. It is therefore worthwhile considering a pre-sale restructuring to bring all the companies under common ownership. A prospective purchaser will then be able to negotiate to buy the group from a single body of shareholders.

In relation to a pre-sale restructuring, under normal circumstances, any disposal of shares (including an exchange for other shares where no cash consideration is received) by an individual shareholder would be treated as a disposal for CGT purposes, and tax would be payable based on the value of those shares. However, under the share for share exchange provisions, where shareholders in one company exchange their shares for shares in another company, and provided the second company ends up owning at least 25% of the shares in the first, there is no CGT disposal, and hence no CGT would arise upon the restructuring.

By way of example, suppose there are two brothers; Aaron who owns Company A, and Barry who owns Company B. They decide together that the two companies would benefit from being under common ownership, and so Barry exchanges all his shares in Company B for new shares in Company A. Assuming the two companies have the same value, Aaron and Barry will each now own 50% of Company A, and Company B will be a 100% subsidiary of Company A. In these circumstances, the share for share exchange rules will apply, and there will be no CGT disposal.

There are, however, anti-avoidance provisions which allow HMRC to effectively override the share for share exchange rules where they consider a transaction has not been carried out for "bona fide commercial reasons". In order to provide companies with greater certainty when applying these provisions, it is possible to apply to HMRC for advance clearance, and for confirmation that the anti-avoidance provisions will not apply to the specific transaction.

The so called "clearance application" is very important because it must disclose to HMRC all the relevant information about the proposed transaction. Failure to disclose any material facts can invalidate the clearance.

At Rawlinson & Hunter we have a great deal of experience in successfully obtaining HMRC clearance for reorganisations, and in enabling clients to demonstrate the business motives for restructuring their businesses. If you are looking for tax efficient ways to prepare your business for sale, we would be happy to speak further with you.

4 Exiting A Shareholder Via A Share Buy-Back

Sometimes, despite everyone's best efforts, in the current economic climate it can be difficult to find a buyer for shares in an unquoted company. Reasons include where:

- An entrepreneur seeking an exit from his or her business is struggling to find a purchaser willing to pay what he thinks the business is worth;
- A management team is unable to find a bank willing to lend them the funds necessary to buy out the owner of a business;
- The younger members of a family company do not have the funds to buy out a dissenting family shareholder who is not happy with the direction in which the family business is moving; and
- The majority shareholder in a company with a legacy of dissenting minority shareholders is not able to raise external financing to buy out the minorities.

A company share buy-back may offer a solution to these issues. This is because the company may be the only relevant party with the funds, or with access to the funds, necessary to buy out shareholders. In addition, provided it has sufficient distributable reserves, a private company is legally permitted to buy back its own shares from any of its shareholders in any combination.

Generally, a share buy-back payment by a company to a shareholder would be treated as a distribution subject to income tax at an effective rate of 25% for 40% taxpayers, or 36.11% for 50% taxpayers. However, with careful planning, a share buy-back payment can be taxed on the shareholder as a capital payment subject to CGT of up to 28%, or as low as 10% where the requirements for Entrepreneurs' Relief are met. However, in order to qualify for this capital treatment, a number of specific company law requirements and tax conditions should be met. These include:

- The company must be an unquoted trading company;
- The share buy-back must be carried out for the benefit of the company's trade;
- The shareholder must be UK resident and have held the shares for at least 5 years; and
- In general, the shareholder must sell all of his shares.

Given the potentially substantial difference in tax rates between the income tax treatment and the CGT treatment of a share buy-back payment, shareholders often require certainty over the tax treatment before agreeing to be bought out. Fortunately, it is possible to apply to HMRC for advance clearance on whether the various conditions above are met, and hence on whether the share buy-back will be treated as a capital receipt subject to CGT.

Rawlinson & Hunter has a great deal of experience in advising clients on share buy-backs and on successfully obtaining advance HMRC clearance. Hence, if you are looking for a cost effective way in which to exit certain shareholders, we would be happy to speak further about the benefits of share buy-backs.

What to do next...

This Briefing is only intended to provide a *snapshot of just some of the ways available to reduce your tax cost* and all of the suggestions, no matter how routine they seem, need careful planning before implementation. If you have seen anything relevant to you which you are interested in considering in more detail, please call the Rawlinson & Hunter partner who normally acts for you. If you are not one of our regular clients but would like more information or advice, a full list of partners is provided on this page and any of them would be delighted to help you.

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