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Selling Your Business:
How to Pay the Minimum Tax and
Boost Your Profits

By Lee Hadnum LLB ACA CTA

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TAX GUIDE - "Selling Your Business: How to Pay the Minimum Tax and Boost Your Profits"

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67 Milton Road
Kirkcaldy KY1 1TL
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About the Author

Lee Hadnum is a key member of the Taxcafe.co.uk team. Apart from authoring a number of our tax guides, he also provides personalised tax advice through our popular Question & Answer Service, a role he carries out with a great deal of enthusiasm and professionalism.

Lee is a rarity among tax advisers having both legal AND chartered accountancy qualifications. After qualifying as a prize winner in the Institute of Chartered Accountants entrance exams, he went on to become a Chartered Tax Adviser (CTA).

Having worked in Ernst & Young's tax department for a number of years, Lee decided to start his own tax consulting firm, specialising in capital gains tax, inheritance tax and business tax planning. Lee now provides online guidance and unique tax planning reports at www.wealthprotectionreport.co.uk

Whenever he has spare time, he enjoys DIY, walking and travelling.

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Introduction

For many people, disposing of their business is one of the key financial events of their life. There's usually a substantial amount of money involved and there are few other cases where the tax implications are as crucial. When you consider that effective tax planning can reduce tax rates to as little as 10% and, in many cases, can eliminate a tax charge completely, failure to give tax issues some careful consideration can be a costly error.

That's why we've written this guide – to give you the key facts about a future disposal of your company or sole trader business to allow you to spot opportunities to slash the amount of tax you'll be paying.

This guide is written as two distinct parts. Part 1 looks at the case where a person is planning to sell a business carried out via a limited company. Part 2 looks at sole traders.

Only one set of these rules will apply to you, depending on how you own your business. If you carry out your business via a company rather than as a sole trader business, your options in terms of a future disposal are much wider and more complex. It's for this reason that over three quarters of the guide focuses on company disposals.

The key point to grasp is that if you are a sole trader you'll own a share of the business assets. Therefore, when you dispose of the business you will be subject to capital gains tax on any gain arising from these assets.

However, if you run your business via a company, it is the company that will own the assets – not you!

Company disposals are more complex because there are different options for structuring the disposal. The two main options are either an asset deal or a share deal.

In an asset deal, if you just want to dispose of the business assets, the company will have to dispose of them and will then be taxed on the gain arising.

In this case, the company would sell the trade and assets and would usually then become a 'shell' with just the cash proceeds from the sale.

If you wanted to access this money, you'd then have to extract the proceeds from the company, and you would usually then pay income tax on the amount extracted.

There is therefore a potential double tax charge in a company – one tax charge in the company and a second tax charge when you extract cash.

The other main option is for you to sell the shares in the company (a shares deal). The beauty of this is that it is usually much more tax efficient for the vendor, as you only incur one tax charge as opposed to the two tax charges on an asset disposal.

However, as you'd expect, matters are not always this straightforward and we've devoted a chapter in Part 1 to look at the circumstances when an asset deal or a share deal is the best option.

We also look at exactly how you'll calculate the tax charges arising on the disposal, but the main part of the guide looks at the opportunities you may be able to use to reduce your tax charge. The kind of things we look at are:

- Type of disposal proceeds
- Getting maximum Entrepreneurs Relief
- Emigration
- Special reliefs such as EIS relief
- Share exchange provisions
- Use of losses
- Cash extraction
- Tax reliefs on transfer of shares or assets
- Uplifting base cost of assets

and much more...

It's important to realise that the capital gains tax (CGT) regime for disposals after 5th April 2008 has changed radically. In particular,

indexation relief and taper relief have both been withdrawn and there is now a flat 18% rate of CGT. In addition, there is a new relief (Entrepreneurs Relief) that can apply to reduce your effective rate of CGT down to 10% in certain circumstances.

We'll look mainly at the new rules (in other words for disposals after 5th April 2008), however as there may be some readers who have sold shares or businesses in tax year 2007/2008 and are looking for information on calculating the gain, we've included a separate chapter on how the old rules apply.

We'll start off by looking at the basic procedure on a disposal of shares or assets before moving on to how we actually calculate the capital gains tax (CGT) due and the tax-saving opportunities you could use to reduce this.

Naturally it is recommended that you seek detailed professional advice specific to your circumstances before disposing of your company.

Part 1

Selling a Company

Chapter 1

Disposal Procedures

If you are considering selling the shares in your company, it's important to realise that you're not just selling a bunch of assets. When you sell the company you are transferring a separate legal entity that owns those assets.

This means that any potential liabilities will usually also pass to the new purchaser. This is a problem for most purchasers as, although they want to acquire the trade and assets, the last thing they want is a lawsuit a few years after the purchase that relates to your ownership period.

When a sale of assets is involved (as opposed to a sale of shares), the past history is not really relevant as any liabilities remain with the vendor.

For this reason, when there is a sale of shares, the purchase and disposal agreement is usually very lengthy and complex because it will look to protect the purchaser as much as possible.

It's all about risk management. The purpose of the detailed contract is to ensure clarity for all the parties involved. One of the ways that the disposal agreement does this is by way of warranties and indemnities that limit the liability of the purchaser. The vendor may also want some indemnities to protect his future position.

Warranties and Indemnities

A warranty is basically a term in the contract stating that one party, usually the vendor, says a particular fact is true.

Given the massive number of potential issues, there are usually pages and pages of warranties to cover as many eventualities as possible.

Common ones could be things like ‘the company is up to date with its PAYE obligations’, or that ‘there is no known litigation’.

By ‘warranting’ a particular fact, the vendor is holding that out as the true position. If it subsequently turns out to be false, the purchaser could claim damages, provided he could prove he suffered some loss as a result of the false statement.

Often you’ll find that the draft contract issued by the purchaser’s solicitors will contain a long list of initial warranties that cover tax and other liabilities. These will frequently not apply as they are just ‘standard warranties’. It is then up to the vendor’s advisers to review the warranties and outline the cases where the warranties are not correct in a ‘disclosure letter’, which is sent to the purchaser. By providing information in the disclosure letter, the vendor protects his position if a subsequent liability arises as a result of this.

For example, a common warranty is that no claims have been made for rollover relief. The purchaser needs to know this because, if a rollover relief claim has been made, a disposal of the asset by the company could lead to a significantly higher taxable gain than would otherwise arise.

In this case you or your advisers would need to review the previous tax computations to ensure that no rollover relief claims had been made. If they had been made, you would insert a provision in the disclosure letter outlining the details (for example, assets involved, date of claim and amount of claim).

An indemnity has much wider scope than a warranty as the vendor undertakes to ‘make good’ the liability. This means that the purchaser would not need to prove any loss arising from the breach – all that would have to be shown is that a claim has arisen. An indemnity is therefore very useful for a purchaser, but would open up a vendor to potentially increased claims.

Limitation of Liability

There are three key aspects that vendors should bear in mind when looking to reduce their potential liabilities:

- Firstly, you should ensure that there is a suitable 'de minimis' limit in place to prevent small and frivolous claims by a purchaser. The level of the limit will clearly depend on the value and particular circumstances of the company being sold.
- At the opposite end of the scale, you should also establish a maximum limit for all claims to be made against you. This would then allow you to budget for the level of risk exposure.
- You should also try and place a time limit on the claims so that no liability will exist unless the purchaser makes a claim before a specified deadline.

Tax Review

When a share sale goes ahead, the purchaser's advisers will review the tax affairs of the 'target' company for at least the previous six years. This is to identify any contentious areas and to make sure that the warranties and indemnities cover all the applicable areas.

Some of the main tax areas that potential purchasers will look at include:

- Identifying the base cost of assets. The balance sheet cost and the capital gains tax base cost could differ substantially if there had been rollover relief claims or if assets were purchased prior to March 1982.
- Whether trade losses will be utilised. We'll look at this later but any trading losses in the company can be carried forward after a change in ownership of the company, subject to various conditions. The purchaser's advisers will want to

review the level of trading losses and identify whether there is an opportunity for them to be offset against profits. This could then, in turn, affect the value of the company and the amount the purchaser is prepared to pay.

- VAT compliance to ensure no undetected errors.
- Group transfers. If the company is part of a group, there are lots of potential risk areas relating to losses claimed via group relief and tax-free inter-group transfers that would have to be looked at.
- Loans from the company to shareholders or directors, which could incur a tax charge.
- Identifying whether any assets have been transferred from the company to shareholders or directors. The company could be subject to corporation tax on gains arising.
- Reviewing whether any gifts have been made by the company that could fall within the charge to inheritance tax for shareholders.

It's clear that the tax review and the subsequent warranties and indemnities are a crucial part of a share sale. Care should be taken over the warranties provided and, wherever possible, the vendor should seek to limit liability.

It may sometimes be preferable for a vendor to engage advisers to provide a full and detailed pre-sale review of the company's tax affairs. A provision could then be inserted in the disclosure letter to protect the vendor should any problems arise. If anything is missed and a subsequent claim does arise, the vendor may then be able to raise a counter claim against the advisers for failure to spot the error and raise the issue.

Sample Tax Warranties

Just to give you more of an idea, I've listed below some of the tax warranties that may appear in a typical disposal agreement.

Note that in practice many of the warranties would be tailored to the particular position of the vendor company. For example, claims for double tax relief may not be relevant to UK-resident companies trading solely in the UK.

Some of the most typical warranties include:

- The company is incorporated in the UK and is, and always has been, UK resident.
- All tax returns due have been made and no tax returns are disputed by the authorities.
- All taxes and national insurance contributions to date have been paid.
- All tax clearances have been disclosed.
- Any available claims for double tax relief have been made.
- No claims for rollover relief have been made.
- The base cost of assets in the accounts is the same as for tax purposes.
- There are no degrouping charges that may arise on the 'target' company leaving the group.
- There are no trading losses carried forward.
- The 'target' company has not issued any debentures.
- There are no loans outstanding to shareholders.
- The company is not, and has never been, classed as a close investment holding company.
- There is no liability for tax under the anti-avoidance provisions (such as the transfer of assets and the controlled foreign companies legislation).
- There are no actual or potential liabilities for inheritance tax.
- Income tax has been correctly deducted from employees' salaries and correctly accounted for to HMRC.

The warranties listed above are some of the less technical warranties. In practice, many of the warranties will list the particular section number (eg, S165 TCGA) and usually you will then need professional advisers to ensure that the warranties you are agreeing to are applicable to your circumstances.

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