Minimising tax liability in business sales
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Introduction

For many entrepreneurs the real reward for the risks and efforts taken in developing a business is the opportunity of a profitable exit – generating a material lump sum profit on selling the business. This article highlights the issues and opportunities to be considered by an entrepreneur who operates the business through a company and who wishes to minimise tax liabilities arising on exit. The article is based on the tax regime in place at 6 April 2011.

Tax planning inevitably takes place against a background of an ever changing set of tax rules. Over the past twenty years or so we have seen a capital gains tax (CGT) regime with rates of tax very much lower than income tax rates, then a move to the same rates applying to capital gains and income, followed by the introduction of reliefs, such as indexation relief and taper relief, which had the effect of reducing the taxable gain or lowering the effective rate of CGT. These reliefs have now been abolished and instead individuals are subject to two rates of CGT. The lower rate of 18% is only applicable to the extent that total income and capital gains in the year in question are less than £35,000. Above the £35,000 figure the applicable rate is 28%. These rates compare favourably with the current top rate of income tax of 50%.

We have gone full cycle, with flat rates of CGT which will usually be materially lower than income tax rates, but now against a background of much more developed anti-avoidance rules, such that many of the more sophisticated planning techniques previously used (sometimes involving trusts and offshore structures) are no longer available.

One principle which has applied for a good many of the years, and continues to be the case now, is that care should be taken to ensure that any profit arising on an exit is not subject to income tax and potentially also national insurance liabilities.

Avoiding income tax and national insurance liabilities

Why should this be a concern to an entrepreneur who sets up a company?

There is a rather crude, and many would say unreasonable, provision in tax legislation relating to shares acquired by employees and/or directors of companies. This provision treats shares acquired by someone who is, or is to be, an employee or director of the company as acquired by reason of the employment or directorship, even where the reality is that the individual is acquiring the shares as the founder of the company and not as a reward of any employment. This deeming provision means that care has to be taken to avoid the application of income tax and national insurance charges.

An example of a situation in which this legislation may apply is when outside investors are involved and require certain restrictions to be imposed on share dealings (e.g. through a shareholders agreement or in the Articles of Association). The existence of such restrictions can bring the income tax rules into play in relation to part of the gain realised on an exit. It is usually possible to avoid problems, but sometimes the advice requires that a specific form of tax election is made at the time of the acquisition of the shares. It should also be noted that immediate income tax consequences can arise if investors (e.g. business angels) are putting some money into the business and they pay a higher price per share than the founder/entrepreneur. This might suggest that the entrepreneur is paying less than market value (in tax terms), with immediate income tax consequences.
These points demonstrate why planning should often start at the time the business is set up, even though a profitable exit is, at that stage, a somewhat distant and even speculative event. In cases where these rules have not been reviewed at that early stage a “health check” would be in order to establish whether circumstances are such that income tax rules may apply and, if so, whether steps can be taken (e.g. before share values rise) to eliminate the problem.

Other circumstances where income tax liabilities could be an issue include the following:

- If the terms of the exit involve an “earn-out” where part of the proceeds of sale is dependent on future profits and on continued employment of the selling shareholder.
- In cases where the company being sold has accrued profits which could be paid out as a dividend (subject to income tax in the shareholder’s hands) and where, for example, there are arrangements under which those profits will be used to finance the purchase price for the shares. Legislation exists to counter such arrangements and impose income tax liabilities on the proceeds of sale. In cases where there is any concern about the application of this legislation (the ambit of which is potentially wide and uncertain) it is possible to apply for an advance clearance that the legislation will not apply.

With care income tax and national insurance liabilities are typically avoidable and the focus is instead on minimising CGT liabilities and ensuring that tax charges do not arise before cash consideration is received.

**Ensuring that tax charges do not arise too early**

It is often the case that at least part of the proceeds of sale is not paid in cash on completion. It may be that the buyer requires at least some of the consideration to be in the form of shares in the purchasing group. It may be that the buyer wishes some of the consideration to be deferred for a period, to help secure potential liabilities under warranties or simply to help with the financing of the acquisition. It may be that part of the consideration is contingent on satisfaction of conditions, e.g. as to future profits.

In any such case the selling shareholder will wish to avoid any tax charge until cash is received (so that funds arising from the transaction are available to pay the tax). Where deferred cash consideration is involved (whether or not contingent) the usual approach adopted is for the consideration in question to be satisfied in loan note form (i.e. a loan recorded in an appropriate legal form). Provided that any paper consideration (whether shares or loan notes) is provided for commercial reasons and not for tax avoidance reasons (a point on which prior clearance can be obtained from HM Revenue & Customs (HMRC)) and the paper consideration is properly structured, the timing problems should be avoided. However, additional issues may arise if entrepreneur’s relief is being sought (see below).

**Minimising CGT liabilities**

Having circumnavigated the above issues the next question will be whether it is possible to improve on a 28% CGT rate. Some opportunities in this regard are referred to below.

*Entrepreneurs’ relief:* When this relief is available the CGT rate is reduced to 10%. A lifetime limit of £10m applies to the amount of gains eligible for the relief (up from the pre-6 April 2011 figure of £5m). The main conditions to be satisfied in order to be able to claim the relief are:
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- The shares in question must be shares in a trading company of holding company of a trading group;
- the shares must represent at least 5% of the company’s ordinary share capital and must have at least 5% of the votes;
- the selling shareholder must be an employee or director; and
- the selling shareholder must have owned the shares for at least one year.

Where a sale involves deferred consideration (e.g. an “earn-out” where part of the consideration is contingent on future profits) problems can arise in securing entrepreneur’s relief in relation to any additional consideration which may become payable at a later date under the earn-out terms. This is because the conditions for claiming entrepreneur’s relief may no longer be satisfied in the period of 12 months leading up to payment of the deferred consideration (e.g. because the seller was not a 5% shareholder throughout that period). Various alternative strategies can be considered to overcome problems of this nature.

Another possibility is the enterprise investment scheme. One or the reliefs available under this scheme provides for an exemption from capital gains tax. However, one of the many conditions to be satisfied is that the shareholder must not be “connected” with the company. This excludes a shareholder who has a stake of more than 30% in the company and also excludes directors and employees (save in limited circumstances designed to allow business angels who might also sit on the board). The scheme is therefore usually not of help to an entrepreneur establishing his own business.

A more radical approach is to be non-resident when the gain is made, since non-residents are not subject to UK capital gains tax. There used to be ways of achieving this by being non-resident for a period as short as one year. However, the rules now provide that someone who has been UK resident for more than a very short period and who becomes non-resident before the gain is made must remain non-resident for five years in order to escape the clutches of the UK tax system. An entrepreneur who needs to have hands-on involvement with the business up to the point of sale and possibly also afterwards (e.g. if part of the consideration is dependent on future profits, responsibility for the delivery of which will fall on the entrepreneur), will need to review whether the rules can in practice be satisfied, even if the individual is in principle willing to undertake a substantial change of living arrangements.

Finally there remains the possibility of a more aggressive (and expensive) form of planning arrangement. Products are developed from time to time which aim to reduce or eliminate tax liabilities. Usually the marketing of these products must be notified to HMRC. As a result they tend to have a short shelf life before counteracting legislation is introduced. The nature of products of this type is also such that they are highly likely to be challenged by HMRC, with a real likelihood of litigation. They are invariably far from being risk free. Where such products are developed they can be fairly aggressively marketed by their promoters (who may look to be paid by reference to a percentage of the savings achieved). There is often value to be obtained from obtaining a second opinion on any such scheme from an adviser who is not involved in its promotion (even where the scheme has the benefit of specialist tax counsel’s opinion). For many sellers achieving a 10% rate under entrepreneur’s relief will be a more than satisfactory basis on which to proceed.
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