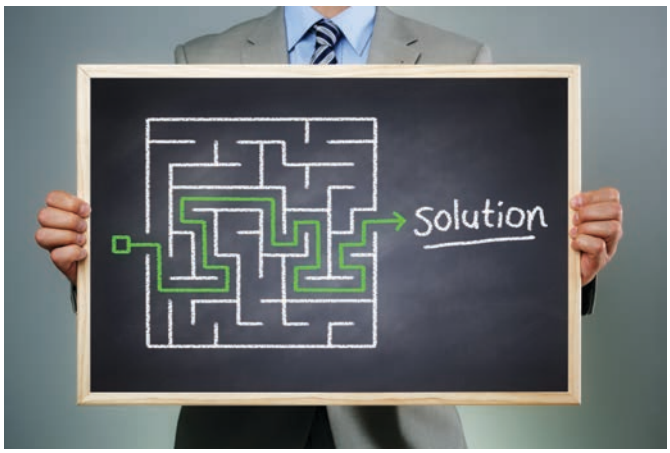
# Looking for a way out…?

**Peter Rayney discusses how some owner-managers have accelerated their retirement plans as a result of the Covid-19 disruption.**





Many owner-managers have experienced a complete shut-down or significant downturn in their businesses as a result of the coronavirus pandemic. If they were already approaching or contemplating their intended retirement, I have seen that the Covid-19 disruption has accelerated these plans in many cases.

These decisions are made easily when faced with the future uncertainty and the prospect of significant losses. Some may have been fortunate to secure a 'distressed sale' of the business, enabling it to continue in some form. In such cases, the owner-manager will rarely have secured a significant payment for the business goodwill. However, the real benefit would be to ensure the future employment of the workforce while avoiding redundancy and other closure costs.

On the other hand, with perhaps the potential threat of insolvency looming, some owner-managers have opted simply to cease trading permanently. Normally, it is not possible to cease trading without suffering a degree of financial pain. There are likely to be closure costs, such as redundancy payments made to employees, lease obligations and so on.

As long as the company remains solvent (after meeting cessation costs), the owner-manager is able to 'control' the process of winding-up the business under a member's voluntary winding-up.

However, although the owner-manager may feel instinctively that 'their' company should be placed into liquidation, it is always important to look at the position on a holistic basis. There may indeed be persuasive commercial reasons to pursue a winding-up – such as contingent trade risks and so on. On the other hand, if the owner-manager requires all or a substantial part of the funds for investment, then it may not be appropriate to liquidate the company after trading has ceased.

**Key points**

- The coronavirus outbreak may prompt entrepreneurs to bring forward their retirement plans.
- Are there commercial reasons to pursue a winding-up?
- Distributions on a dissolution of more than £25,000 will be treated as income.
- Business asset disposal relief may apply if all conditions are satisfied for two years before cessation of trading.
- If a winding-up is for tax avoidance purposes, the anti-phoenixism legislation may apply.
- Substantial cash balances in a company may not prejudice trading status.
- The tax advantages of family investment companies.

## Extracting the company's retained reserves

In most cases, when owner-managers wish to close their company down, they will find that it is more tax efficient to extract the company's reserves (and share capital and the like) by a placing the company into a formal member's winding-up.

Any distribution made during the course of a winding-up cannot be an income distribution (CTA 2010, s 1030). Instead, distributions made by a liquidator are treated as capital distributions and normally fall to be taxed at more favourable rates under the capital gains tax regime (TCGA 1992, s 122(5)(b)).

Broadly, a shareholder's receipt of a capital distribution is treated as a disposal of an interest in the relevant shares for capital gains tax purposes (TCGA 1992, s 122(1)). If several capital distributions are made, each one, in effect, represents a part disposal of the shares. In some cases, the liquidator may make an in-specie capital distribution of one or more assets to the shareholders. This will generally involve a deemed market value disposal of the asset(s) by the company. Further, the recipient shareholder is also deemed to receive a taxable capital distribution equal to the market value of the asset (TCGA 1992, s 17(1)(a)).

If the company has substantial reserves (in other words, more than £25,000), the temptation to simply dissolve the company must be resisted. Since 2013, HMRC no longer treats amounts distributed on the dissolution (the 'striking-off') of a company in the same way as liquidation distributions. If the

amount distributed on a dissolution exceeds £25,000, the entire amount will be treated as an income distribution, which is likely to be taxed at the penal tax rates of 32.5% or 38.1%. Therefore, a member's voluntary winding-up is invariably more tax efficient than a dissolution, notwithstanding the additional legal costs involved with a liquidation.

However, some owner-managers may prefer to keep the company alive for several years, and pay out the distributable reserves within their 'basic rate' bands over several years so as to benefit from a 7.5% income tax charge.

## Anti-phoenix rules

Advisers should remember that the beneficial capital gains tax treatment of capital distributions may be denied if the shareholder intends to carry on the same or a similar trade or business in another company or business 'vehicle'.

In essence, if the winding-up is driven mainly by the avoidance of income tax, potentially, the anti-phoenix legislation in ITTOIA 2005, s 396B applies to any liquidation distribution. This applies to a capital distribution if the recipient shareholder starts the same or similar trade or business (within any business format) within the following two years. In such cases, HMRC would normally seek to tax the purported capital distribution as an 'income' dividend at higher income tax rates. Clearly, if shareholders are liquidating on their full retirement from business life, HMRC generally accepts that this is not motivated by income tax avoidance and therefore the anti-phoenix legislation should not be in point.

## Obtaining business asset disposal relief

If the company was trading previously, it may be possible to secure the beneficial 10% capital gains tax rate on the capital distribution gain under the business asset disposal relief (BADR) provisions – this being the new name for entrepreneurs' relief since 6 April 2020.

The BADR legislation contains special rules for capital distributions. Since 6 April 2019, the applicable 10% capital gains tax rate is available for capital distributions as long as the recipient shareholder satisfies *all* the relevant conditions *throughout* the 24 months before the company ceases to trade. These conditions can be summarised as:

- the company must be a trading company (or a member of a trading group);
- the shareholder must have satisfied the 'personal company' test – in other words, held at least 5% of the company's ordinary share capital, voting rights and economic rights (as defined in TCGA 1992, s 169S(3)); and
- the recipient shareholder was an employee or director of the company (or any member of the trading group).

Further, the relevant capital distribution must be made within three years of the 'trade cessation' date.

The conditions are summarised in ***BADR tests***.

Following the Budget 2020, an owner-manager's lifetime entitlement to 10% capital gains tax under BADR or entrepreneurs' relief is limited to the first £1m of their 'capital distribution' gains (less any gains subject to a previous claim). Thus, if they had already enjoyed entrepreneurs' relief on at least £1m of eligible gains before 19 March 2020, they would have no BADR allowance left.

If an owner-manager is entitled to the full BADR lifetime gains allowance, the first £1m of gains (after deducting the annual capital gains tax exemption) would be taxed at 10%, with any excess gains being taxed at 20%.

## BADR 'trading company' status

The BADR rules are quite stringent in that they require the company to be wholly trading; although non-trading activities are ignored as long as they are not substantial (TCGA 1992, s 165A(3)). In practice, HMRC will accept that this 'de minimis' rule is satisfied if the 'non-trading' element does not exceed 20% of the total activities.

If a company has accumulated substantial cash balances, this should not necessarily prejudice its 'trading status' for BADR purposes. Although perhaps a borderline case, the ruling in *J and N Potter v HMRC* (TC7348), emphasises the importance of looking at the company's actual activities rather than a simple narrow assessment of its assets.

Therefore, when determining whether a company satisfies the 'trading status' for BADR, its turnover, income, expenses, management and employee time are likely to be influential factors. In the *Potter* case, the trade had all but collapsed in the 2008 financial crash but, crucially, the director continued to try to seek new business and contracts. This was a persuasive factor in concluding that the company was still trading for the required period despite the fact that its assets were largely made up of sizeable investment bonds.

If there are any doubts about a company's trading status – for example, because the company has some investment property – it is well worth making an advance application to HMRC under the 'non-statutory' business clearance procedure to confirm that the company qualifies as a trading company.

This is illustrated by the case study of ***Wonder Garden Centres Ltd***.

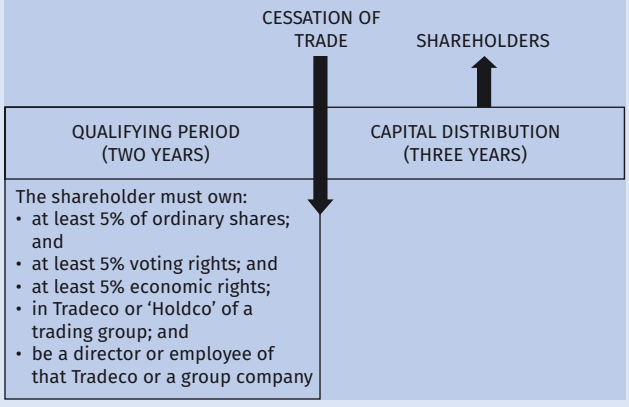
## Wonder Garden Centres Ltd

The Wonder Garden Centres Ltd (WGC) is 100% owned by Syreeta (56 years old), who subscribed for the company's entire 1,000 £1 ordinary shares at par in June 1992.

WGC operates from two garden centres in Bedfordshire, which are held on short-term leases. Although the business

**BADR tests**

Summary of BADR conditions for a capital distribution on a winding-up



was very successful until 2015, in recent years its trade has slowly declined as a result of intense competition and it has made small losses. However, because of the Covid-19 lockdown, it was unable to open its garden centres for three months and it has suffered substantial stock losses. The staff were furloughed during this period. The break-clause on the two leases will be triggered in December 2020.

As a result of all these factors, Syreeta made the difficult decision to cease trading permanently on 30 September 2020. She estimates that her overall closure costs will be about £110,000, including redundancy payments and 'negotiated' rent to the end of December 2020.

However, after all the closure costs and other creditors have been paid, her accountant has estimated that the company will have residual funds of some £320,000, as shown below:

| | £ | £ |
|---|---|---|
| Current assets | | |
| Receivable for the sale of trees, bushes and plants | | 17,500 |
| Bank | | 495,380 |
| *Less*: | | |
| Current liabilities: | | |
| Trade creditors | 33,800 | |
| Closure costs (redundancy payments and rent obligations) | 110,000 | |
| VAT and PAYE/NICs | 49,000 | 192,800 |
| | | 320,080 |
| Financed by: | | |
| Share capital | | 1,000 |
| Profit and loss account | | 319,080 |
| | | 320,080 |

Syreeta will therefore place the company into formal liquidation. Allowing for liquidation and other costs, assume that £310,000 is available for Syreeta (the 100% shareholder).

Syreeta's estimated capital gains tax liability on the capital distribution will therefore be £29,670, as calculated below:

| | £ |
|---|---|
| Capital distribution | 310,000 |
| *Less*: base cost of shares | 1,000 |
| Capital gain | 309,000 |
| *Less*: annual exemption (2020-21) | 12,300 |
| Taxable gain | 296,700 |
| BADR @ 10% | 29,670 |

**Planning point**

If entitled to the full BADR lifetime gains allowance, the first £1m of gains (after any annual exemption) are taxed at 10%, with any excess gains taxed at 20%.

Because Syreeta intends to permanently retire from business, HMRC is unable to apply the anti-phoenix rules and thus there is no risk of a 'dividend' income tax charge arising on her capital distribution.

## Conversion to a family investment company

Unless the owner manager has been able to secure a sale of their business, their natural instinct will often be liquidate the company at the end of its trading life.

However, some owners may be looking to invest the company's retained funds by, say, buying a property or other form of investment. In such cases, it makes little sense to trigger a tax charge on the extraction of the proceeds from the company. The preferred option will often be for the existing company to reinvest the monies in buying the 'new' investments. The company could therefore become a family investment company. This can provide a useful vehicle for future estate and inheritance tax planning. Normally, if a company becomes a family investment company, it will be necessary to amend its articles of association and to draw up a suitable shareholders' agreement.

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Family investment companies have several tax advantages. First, they can receive dividends from other companies without any further tax charge. Second, the shareholders can control their income tax charge by suitable dividend extraction strategies. Third, these companies work particularly well if the investment income is retained by the company over a long-term period (rather than being paid out to the shareholders). Finally, owner-managers may also consider suitable transfers of shares to their children though a discretionary trust. ●

**Author details**

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