Keeping it in the family

The issues that should be considered when disposing of the family business.

KEY POINTS

- Impact of cash on a company's trading status.
- How selling shares can benefit the trade.
- Buyouts may be a more satisfactory way of passing on the company.

How to pass a family company from the parents to the children was discussed in the Readers' forum query Retirement plan. Several aspects of the planning require more detailed consideration than was possible within the confines of the Readers' forum, and I will look at these in more detail as well as other ways in which the succession planning could have been carried out.

The trading company was owned 50:50 by a husband and wife, who were in their early 60s. The company had £8m cash and £9m reserves and the parents wanted to pass the majority of the company to the children, while taking some cash out themselves. Of £50,000 share capital, the parents were going to give 10,000 £1 shares to their children, relying on the gift relief at TCGA 1992, s 165. The company would then buy back 35,750 shares from the parents.

The parents would apply for the relief available under CTA 2010, s 1033 so that the sum received would be treated as a capital gain and charged to capital gains tax at 10%. This would leave the parents holding 29.8% of the share capital: 4,250 shares out of 14,250.

Cash and entrepreneurs' relief

https://www.taxation.co.uk/Mvc/Views/PrintPreview.html#Keeping it in the family
Large amounts of cash on the balance sheet may influence whether a company is deemed to be a trading company. HMRC’s guidance is helpful, but it is not always as clear as it could be. A trading company is one whose activities do not include, to a substantial extent, activities other than trading activities (TCGA 1992, s 196S(5)). It is covered in HMRC’s Capital Gains Manual CG64090, but note that the guidance in this part applies equally to whether a company is a trading company for the purposes of entrepreneur’s relief or for the substantial shareholdings exemption (SSE) because the tests are identical.

Is there an activity?

Most people start by considering the fact that there is a large amount of cash on the balance sheet (in the query, £8m, although we do not know what other assets there are) and ignore the wording of the statutory test. HMRC’s guidance says: “the question to ask is how should a company’s non-trading activities be measured to assess whether they are substantial?” It is important to note that the word “activities” is emphasised in the manual. The point that most people miss is that, fundamentally, for there to be a substantial non-trading activity, it is necessary first to find an activity.

Putting it another way, is the mere holding of cash an activity at all? I would suggest that in most cases holding cash is passive and no activity is involved. Therefore, we do not need to consider any of the other guidance in the context of whether this is non-trading activity and whether it is substantial.

In my view, this also corresponds with the policy behind the reliefs because I have never seen any suggestion that entrepreneurs’ relief (or the SSE) was intended to apply only to companies that distribute most of their profits. So there is no reason why a company that has not distributed its profits should cease to be considered a trading company for these purposes. The tests are, though, very different for inheritance tax.

Is the activity substantial?

It could be said that any decision on how or where to invest surplus cash may, itself, be an activity, in which case it is necessary to consider whether it is substantial. The guidance suggests that, if an activity is identified, other features should be looked at, including the company’s asset base, income from non-trading activities and their resource cost. In such cases, the time spent managing surplus funds is likely to be trivial in the context of the overall activities of running the trade of the company and, generally, income from invested surplus cash is also a very small proportion of the trading income. So I would conclude that, even if managing the cash is in any way an activity, it is hardly likely to amount to being a substantial one.

On the question of the asset base of a company, I consider this the least important test, simply because, in my view its asset base is not really a measurement of activity.

Is it a non-trading activity?

All of the above is predicated on the proposition that the cash is not general trading cash. If all that is happening is the holding or management of working capital, there is no reason to suggest that any of the activities involved in managing that cash are anything but trading activities. Again, the query offers little information about this.

Overall, however, it seems unlikely in most cases that a substantial holding of cash will necessarily mean that the company has substantial non-trading activities and ceases to be a trading company for entrepreneurs’ relief or SSE.

Trade benefit test

Normally, a company purchase of own shares would be treated as a distribution for tax purposes because the amounts received exceed the sums subscribed for the shares (CTA 2010, s 1000(1)(B). An exception is made if certain conditions are met, such that the amounts received can be treated as capital, if requested, CTA 2010, s 1033 et seq.

One of the conditions is that the purchase of own shares “is made wholly or mainly for the purposes of benefiting a trade carried on by the company” (CTA 2010, s 1033(2)(a)), so the main benefit of the purchase of own shares must be to the trade of the company and not to the exiting shareholders.
Can selling shares benefit the trade?

In a case such as that in the query, one might take the initial view that this is all about the benefit to the parents because they can cash in their life-long investment and pass the business to their children. This view is made explicit by HMRC in their statement of practice 2/1982 “Company's purchase of own shares”, which makes the use of a company purchase of own shares more difficult in succession planning cases.

To access the capital treatment it is necessary to make the case that the trade would benefit from being passed into the management of the children or that the continued presence of shareholders who wish to retire would be detrimental to the business.

In the query, it was suggested that the children were not yet ready to take over the business without continued parental guidance, so it was always going to be difficult to demonstrate to HMRC that passing the business to the children would immediately benefit the trade.

Arguably, it is likely to be very rare that the change of shareholders has a direct read-across to the success of the trade. The statement of practice cites buying out a controlling shareholder who has retired as a director to make way for new management or, outside shareholder who provided equity finance that is no longer required.

The most obvious example, which is not in the guidance, but one that I have seen many times, is when there is a dissenting shareholder with a substantial holding so that running the company and its trade becomes more difficult because of the differences of opinion across the board table. In that case, it seems far more obvious that buying out that dissenting shareholder would specifically benefit the trade.

Be that as it may, the statement of practice shows that HMRC accept that a purchase of own shares in the context of succession planning can legitimately be treated as benefitting the trade. Paragraph 3 states that, although HMRC will expect exiting shareholders to sell all their shares, they will accept in some cases that a maximum holding of 5% could be retained for sentimental reasons.

How valid is HMRC's approach?

This point was mentioned in both answers to the query because the parents would retain 29.8% of the share capital. But the statement of practice is HMRC’s view only on the operation of the trade benefit test in the context of the purchase of own shares.

Nothing in the legislation backs up their view. Once it is accepted that a purchase of own shares can legitimately be used for succession planning or that succession planning is for the benefit of the trade, it does not follow to me that the shareholders must reduce their shareholding to a minimum 5% as HMRC suggest.

In this case, a mother and father have a controlling interest between them, 100%, which they plan to reduce to less than 30% in favour of their children. That puts the children in control, which is clearly a succession. If it is considered that the business will benefit from being run by the children in the future, it is hard to see how that benefit is demonstrated better by the parents having fewer shares. Indeed, if the scenario is that the parents felt that, for now at least, the children require further guidance, then the retention of 30% of the share capital is a sensible commercial move, because it allows them some influence over the company’s affairs.

So HMRC's view in this area can be challenged, particularly since that view dates back some 33 years and the commercial world has moved on. Further, HMRC’s view does not sit comfortably with some of the more common succession planning structures available.

Is there a better way?

There is no reason why a purchase of own shares should not be used for succession planning. It is, however, far more common for a succession to be structured as a buyout instead.

Structuring a buyout

Typically, using the query, the children might form a new company, say BidCo, with £10,000 of share capital (to fit the numbers above). BidCo would then buy the entire share capital of the trading company from the parents. The consideration would be the issue of 4,250 shares to the parents with loan notes for the rest of the consideration.
These can be redeemed out of current reserves and future profits of the trading company by paying dividends to BidCo to fund the repayments.

Assuming the conditions are satisfied, the parents will pay capital gains tax as and when the loan notes are redeemed, because this is a share exchange to which TCGA 1992, s 135 should apply. There are several permutations on this theme but we shall stick to this one example.

Advantages of a buyout

There are several advantages of a buyout over a purchase of own shares. First, the combination of tax and company law requires that a purchase of own shares be funded in full and in cash. It is not possible to structure a purchase of own shares by issuing a form of loan notes or by deferring the payment of the consideration. Nor is it possible to satisfy the consideration by transferring assets from the company to the outgoing shareholders. So in cases where the proposed price exceeds the cash held by or available to the company, a purchase of own shares is not possible. In contrast, a buyout is almost invariably structured with some element of the consideration being deferred and repaid out of future profits.

Second, the rollover treatment, whereby the parents do not pay capital gains tax until the loan notes are redeemed, is available as long as the transactions are carried out for bona fide commercial reasons and are not parts of schemes or arrangements to avoid capital gains tax or corporation tax (TCGA 1992, s 137(1)). There is general acceptance that the sale of the company is a bona fide commercial reason (see the House of Commons debate on this point in Hansard, 25 July 1977, volume 936, columns 200 to 203, and the comments of Sir Andrew Morritt in the High Court in Snell v CRC [2007] STC 1279 (paragraph 12)).

This test is different from the trade benefit test for a purchase of own shares. For the favourable capital gains tax treatment, the parents have only to demonstrate that they have a commercial purpose for carrying out the transaction, which is their retirement from the business and realisation of their investment. There is no indication that they plan to avoid capital gains tax because the tax consequences are not affected by the identity of the vendors. In other words, they are paying the same tax as they would if they sold the company to a third party on identical terms. But it is clear that the focus of the test for the share exchange relief is on the purposes of the vendors not the impact on the trade. Indeed, there is nothing in statute or practice to prevent the parents selling the company to someone who they know will fail dismally if that person happens to be paying them the best price for the shares.

The third advantage is more esoteric, but we have seen from the earlier discussions that a case in the query would contravene HMRC’s guidance for the capital treatment on a purchase of own shares. So it is unlikely that clearance would be granted and, if the transaction were carried out as described, it may well be challenged by HMRC and end up at the tax tribunals or the courts at great expense to the taxpayers.

There is no such problem with the share exchange treatment. In technical terms, it is only necessary that BidCo acquire more than 25% of the shares of the trading company (TCGA 1992, s 135(2) Case 1). HMRC will usually grant clearance in these cases so long as that condition is satisfied.

For practical purposes, HMRC’s view of the transactions in securities legislation is that they tend only to grant clearance under those provisions (ITA 2007, s 701) when the vendors are giving up a controlling shareholding. In the query the parents are retaining only 29.8%, so any difficulty obtaining the requisite clearances from HMRC under both the capital gains and the transactions in securities rules would be unexpected.

Conclusions

Perhaps the overriding practical message is that, although there is no technical reason why the succession planning using a purchase of own shares cannot work, there are practical difficulties in obtaining HMRC’s approval for the mechanism in this case, and in the fact that the company will have to find all of the cash required to pay the full purchase price upfront.

In contrast, it will generally be easier to obtain HMRC clearances for a buyout and the consideration can be deferred over several years.
[3] https://www.taxation.co.uk/category/content-type/comment-analysis