TAXATION
Your partner in tax law, practice and administration

Published on *Taxation*(https://www.taxation.co.uk)

04 December 2018

Readers' forum: Exit plan

Transfer of company shares to son.

A small limited company (OldCo) has traded for many years and has a modest amount of money in the bank. The sole shareholder and director is planning a gradual exit over the next five to ten years.

He has appointed his son as a director of the company. The son would like to buy 20% of the shares from his father at a fair value but cannot finance the purchase. His plan is that: the son will form his own limited company (NewCo) to buy the shares; his father will sell the OldCo shares to NewCo at a fair value, without any restrictions; NewCo will borrow some money from OldCo to partly pay his father for the shares the debt between the two companies will be repaid over five years from part of the dividends that NewCo will receive from the trading company, OldCo; and the remaining amount payable to the father will be paid over five years, again from part of the dividends that NewCo receives from OldCo.

Interest will be charged on the loans, and loan agreements will be prepared to protect all parties. Can readers think of any reasons why this plan would not work or be acceptable to HMRC?

Query 19,275– Doorman.

Reply by Pete Miller,The Miller Partnership

Pre-transaction clearance can usually be obtained from HMRC.

The structure proposed by Doorman is a typical management buyout structure, used to self-fund the sale of a company. Its beauty is that an exiting shareholder can sell his shares to NewCo in return for cash or, if the company does not have enough cash, for the issue of loan notes and possibly some shares. In many cases, the shareholder can use the share exchange rules (TCGA 1992, s 135) to defer paying capital gains tax on the disposal until loan notes are redeemed. From the purchaser's perspective, dividends can be paid from the subsidiary to NewCo without any loss of tax to settle any loan notes. Pre-transaction clearance can usually be obtained from HMRC on the commercial bona fides of the transaction if the department is satisfied that no tax avoidance is contemplated. The shareholders then have some reassurance as to the tax treatment.

It appears that Doorman is suggesting the BidCo be used to acquire only 20% of the father's shares. It would be more usual for BidCo to acquire the whole shareholding and to issue shares to the father as part of the consideration so that he ends up with 80% of the shares of BidCo. The comments below apply whichever route is taken.

The details of the structure proposed by Doorman will require some tweaking to deal with two main tax issues. The first is Doorman's suggestion that the trading company will lend money to the holding company to fund part of the purchase price. I have suggested already that this is usually done by way of dividend because a loan is likely to trigger a charge under the loans to participator rules. CTA 2010, s 459 imposes a corporation tax charge under these rules if there is a loan that is not to a participator, followed by a payment to a participator. Thus, the loan could generate a quasi-corporation tax charge at 32.5%, with the tax being repayable only as the loan unwinds. It is fair to say that not everybody shares this view of s 459 (see 'Close company loans and participators' by David Southern QC, Tax Journal, 10 February 2017, page 12 – tinyurl.com/yab8puv8) but it is certainly HMRC's view and is the prudent approach taken by most advisers.

The simple answer, of course, is just to use dividends, not loans.

The other problem we have is the transactions in securities legislation. The effect of a buyout structure is that the profits of the company fund capital payments to the vendor shareholder or shareholders, which HMRC considers unacceptable if those shareholders still retain control of the company. This is precisely the sort of 'abuse' that the transactions in securities rules were intended to prevent.

In contrast, HMRC accepts that, if a shareholder is exiting or largely exiting from their business, the commercial drivers override any perceived income tax advantage, as though the shareholders concerned were simply selling their shares on the open market. In this case, unfortunately, we are on the wrong side of the line because the father is retaining 80% of the shares. If the vendor shareholder is retaining a controlling interest in the subsidiary company, as here, or has such an interest in NewCo, HMRC almost invariably takes the view that the transactions in securities rules should apply. The capital sums received would then be subject to counteraction and, in effect, charged to income tax as if those sums had been a dividend. That seems by far the most likely outcome in this case. However, there may be a way out.

If, instead of the proposed structure, NewCo were to buy all the shares of HoldCo, it could pay consideration to the father in the form of 80% of the enlarged share capital of OldCo plus a loan note for the agreed amount of cash. So far, this is not materially different from the previous proposal, but the important point is that the father should undertake not to redeem the loan note until he makes a much more substantial disposal to take his holding down to well below 50%. In these cases, HMRC will treat the loan note as a reinvestment into the business and, generally, will not invoke the transactions in securities rules. Although the father may not be able to take any cash out of the company immediately, it may be possible for him to arrange personal lending secured on that loan note, so that he can still obtain some cash in the short to medium term before his retirement.

In many cases we would also be warning here about the importance of considering the employment related securities rules. This would be in terms of the price paid by the incoming shareholder for his stake in NewCo and whether that would, in this case, constitute a sensible market value for a 20% holding. However, here we are probably saved by the family relationships clause in ITEPA 2003, s 421D because the rules do not generally apply if shares are obtained at undervalue because of a person's family relationships.

A closer look ...

Exchange of securities and TCGA 1992, s 135

The reply to 'Exit plan' refers to the rules on the exchange of securities (TCGA 1992, s 135).

Simon's Taxes says that such exchanges fall within the share reorganisation rules (TCGA 1992, s 126 to s 131) and therefore should be neutral for chargeable gains tax purposes. Broadly, an exchange of securities is when one company (company B) acquires shares in, or debentures of, another company (company A) and in exchange issues its own shares or debentures.

The rule applies whether or not the exchange is intra-group or with a third party (in other words, an intra-group exchange of securities will not be treated as falling within the no gain/no loss provisions (TCGA 1992, s 171)).

If the qualifying circumstances apply, company A and company B are treated as the same entity and the exchange is treated as a reorganisation of its share capital (see TCGA 1992, s 135(3)).

The basic effect of this is that a person who exchanges shares in, or debentures of, company A for shares in, or debentures of, company B is treated as not disposing of their old shares or debentures. Instead, these are treated as the same asset as their new shares or debentures, acquired as the old shares or debentures were acquired.

There are three sets of circumstances when the provisions apply:

- When company B acquires as a result of the exchange, or already holds, more than a quarter of the ordinary share capital of company A.
- When company B makes a general offer to all the shareholders in company A (or to all the shareholders of a particular class) and it is made on the basis that, in the first instance, company B would gain control of company A. This condition meets the situation in which an offer is made initially on condition that the offeror will obtain control of the target company and is later made unconditional but proves unsuccessful in that the offeror does not come to hold more than 25% of the issued share capital of the target company.
- When company B acquires as a result of the exchange, or already holds, the majority of the voting power in company A.

As for a scheme of reconstruction in which the relevant shareholders (together with persons connected with them) hold more than 5% of the shares or debentures of the acquiring company (TCGA 1992, s 137(2), (3)), the no-disposal rule on an exchange of securities applies only if the exchange:

- is carried out for bona fide commercial reasons; and
- it does not form part of a scheme of arrangement the main purpose (or one of the main purposes) of which is the avoidance of capital gains tax or corporation tax (TCGA 1992, s 137(1)).

Back to top

Tax Topic Tags: Forum & Feedback [1]

[2] [2]

SourceURL: https://www.taxation.co.uk/Articles/2018-12-04-338964-readers-forum-exit-plan

Links:
[1] https://www.taxation.co.uk/category/content-type/forum-feedback