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05 June 2018

Readers' forum : Retirement plans

Tax treatment of loan from retiring shareholder to former close company.

My client, the founding director and majority shareholder of a close trading company (a property lettings agency), is approaching retirement and is in talks with the other director shareholders about his exit plan. This involves the company purchasing all of his shares and applying for capital distribution treatment and consequently a claim for entrepreneurs' relief.

I am satisfied that the rules for such an application will be satisfied with the exception of those concerning post-sale interests. These are proving to be a problem because the director intends to loan the company £100,000 over the next two years to fund working capital. This would breach the rules that deal with the seller being connected with the company immediately after the sale (CTA 2010, s 1062).

For the sake of completeness, the company has reserves of £300,000 which would be extracted through the buyback and then £100,000 will be loaned back to provide working capital.

Having looked at the legislation and the definition of participator at CTA 2010, s 454, it seemed that this problem might be avoided by the director making loans to the other director shareholders (who are not family members) who could then loan the capital to the company. My reading then of the CTA 2010 is that sub-s 1042(1) is irrelevant because the retiring shareholder would not be connected. However, it has been pointed out to me that sub-s 1042(2) would operate to deny capital treatment for the distribution. Having read this subsection several times, I am no closer to understanding it and can find little commentary to help (*Simon's Taxes* at D6.615 is mostly preoccupied with shareholdings).

I would be grateful for any clarification readers could offer on the application of sub-s 1042(2), whether they agree it operates to deny capital treatment.

Query 19,176– Stumped.

Reply by Pete Miller, The Miller Partnership

Stumped is quite correct in saying that the provisions of CTA 2010, s 1042(2) are somewhat impenetrable. Nor is there anything helpful in HMRC's manuals. However, my reading of the situation is that for s 1042(2) to be in point, either the seller or an associate must own an interest in the company that would fail the conditions at CTA 2010, s 1037 or s 1039. Clearly, the seller will not have such interests because that is precisely the point of the planning. But the seller is not associated with his fellow shareholders by any of the tests of association in CTA 2010, s 448. So my instinct is that this planning is robust.

In any case, if Stumped is intending to carry out the transaction on behalf of his client, he will be applying for clearance under CTA 2010, s 1044. So long as full disclosure is made, including disclosure of the intended loans, it may be that HMRC will grant clearance on the basis that it is comfortable that this triggers neither s 1042(2) nor falls foul of the anti-avoidance provisions. After all, if there is a genuine commercial requirement to make the loans and the person chooses to make what are likely to be relatively poorly secured loans to individuals –rather than a secured, formal loan to the company – there are clear economic consequences to the way in which the loan is structured as well.

There is an alternative transaction to which HMRC should grant clearance.

If the remaining shareholders were to set up a special purpose company to buy out the existing one, this ‘BidCo’ could buy the trading company, issuing new shares to all the shareholders who intend to remain in place, and paying cash consideration to Stumped’s client, along with a loan note for the £100,000 that he intends to lend to the company. The remaining shareholders should be subject to TCGA 1992, s 135 (‘Exchange of securities for those in another company’) so that no tax charge arises and the new shares stand in the shoes of the old ones.

The exiting shareholder will pay capital gains tax on his cash consideration in the normal way. If he is not holding any shares in the company after the transaction, he would also probably make an election under TCGA 1992, s 169Q to treat the share-for-loan note exchange as a disposal so that he pays capital gains tax at the entrepreneurs’ relief rate on the deferred consideration.

This leaves a structure in which the remaining shareholders own BidCo. This in turn owns the whole of the trading company and BidCo owes the departing shareholder £100,000, which is the loan that is intended in this case.

Although the insertion of a new company might add a little to overall costs in future, this is a transaction many companies carry out routinely when a shareholder is leaving, particularly if they cannot satisfy the conditions for a company purchase of own shares. And it seems particularly apposite in this case, when the loan-back is causing some concerns as to whether the capital treatment on such a purchase would otherwise be available.

Editorial Note.

We wondered whether Stumped’s proposal would be caught by CTA 2010, s 1033(2). Under this a payment by a company on the redemption, repayment or purchase of its own shares is not a distribution for the purposes of the Corporation Tax Acts if … Condition A or Condition B is met. Section 1033(2) says ‘Condition A is that:

(a) the redemption, repayment or purchase is made wholly or mainly for the purpose of benefiting a trade carried on by the company or any of its 75% subsidiaries;

(b) the redemption, repayment or purchase does not form part of a scheme or arrangement the main purpose or one of the main purposes of which is:

(i) to enable the owner of the shares to participate in the profits of the company without receiving a dividend; or

(ii) the avoidance of tax; and

(c) the requirements set out in sections 1034 to 1043 (so far as applicable) are met.’

Perhaps this is where doubt may arise on whether Stumped’s proposal will fall foul of the anti-avoidance provisions. Presumably, the suggestion that a BidCo be used pushes this potential problem to one side.

A closer look ...

Company purchase of own shares

The reply to 'Retirement plans' suggests how a retiring shareholder may receive a capital distribution on the purchase by a company of its own shares. *Simon's Taxes* at D6.657 says many commentators suggest the use of capital transactions as a tax-efficient method of extracting profits. Clearly, such transactions are not generally appropriate to withdraw profit regularly because they involve an element of finality. However, they may be suitable if the business proprietor retires, for example.

One advantage of such a transaction is that gains are taxed at a flat rate of 10% or 20% if the total taxable income of the individual exceeds the income tax basic rate. Gains that accrue on or after 23 June 2010, and before 6 April 2016, were taxed at a flat 18% or 28% if the total taxable income of the individual exceeded the income tax basic rate band.

Disposing of shares generally involves a sale, liquidation, or company repurchase of own shares.

The first of these can give a capital gain that might be relieved by offset against other capital losses, but the latter two may be more problematic.

The repurchase of own shares by a company is treated as a distribution and is subject to income tax unless the conditions in CTA 2010, s 1033 and the subsequent provisions are satisfied. If the conditions are met, the transaction may be treated as giving rise to a capital gain. The company can seek clearance to this effect under CTA 2010, s 1044 and s 1045.

CTA 2010, s 1033 requires that the repurchase of shares should not form part of a scheme or arrangement, one of the main purposes of which is either to enable the share owner to participate in the profits of the company without receiving a dividend or the avoidance of tax.

If the company's history shows the accumulation of retained profits within the company, it is difficult to see how this condition could be satisfied.

If the condition is not satisfied, clearance is likely to be denied and, again, the payment will be treated as a distribution with a corresponding income tax charge.

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