

Setting up your business – part II

Planning ahead

By Alan Zeffertt

Probably the last thing on your mind when planning your new company is how to sell it on when the time comes.

Yet succession planning for your business is essential for the long-term future of the company – and perhaps too for your own financial security.

Part I of Setting Up Your Business covers the various forms of business structure. Part II considers these structures, and how to plan for the future, in further detail.

Selling the business: what to sell?

If you are one of a number of participants in the business, it may be easier to find a buyer for your shareholding than to sell your partnership share, as the latter would technically involve the dissolution of the partnership.

It may also be easier to sell a majority stake in a company, as this will pass control to the purchaser. The right to buy minority shareholders' stakes may also prove attractive to a would-be buyer.

It is possible for a company, LLP or partnership to include in its constitutional documents procedures for sale, including giving other participants the first right of refusal.

Tax considerations

What if the business is holding chargeable assets which will probably realise a significant capital gain – for example, land? The tax implications will differ depending on whether the business is a partnership or LLP, as compared with a limited company.

In the case of a partnership or LLP, there is only one disposal by the partners or members, which will attract capital gains tax of up to 40%, subject to the availability of taper relief. The proceeds are treated as belonging to the partners or members of the LLP, in proportion to the surplus assets they share. Each will pay their share of the gain, but without further tax charge.

On the other hand, the same sale by a limited company would result in a 30% corporation tax charge for the company – or 19% if the small companies rate applies. Additionally, if the company is liquidated or the shares sold, shareholders would have to pay capital gains tax of up to 40% on the increase in value of their shares attributable to the gain in the value of the underlying asset.

So, when the value of company assets increases, those assets are potentially subject to a double tax charge.

Furthermore, taper relief - available to individuals - is not an option for the chargeable gains of companies continuing to receive indexation relief.

Reduced tax rates for dividend income
There is no escaping the fact that being in business means incurring taxes, but reduced rates of tax do apply to dividend income and the non-repayable tax credit attached to it.

In terms of flexibility and simplicity, the unincorporated business has a lot going for it. But for many businesses, the limited liability conferred by incorporation will be the deciding factor.

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Benefits of incorporation

Let us say that a sole proprietor, partners or members of a LLP wish to transfer their business to a limited company, in exchange for shares in that company. They can do so without any being liable for any capital gains tax (CGT), because it is possible to apply to 'roll over' or 'hold over' any gain which would otherwise accrue. Inheritance tax (IHT) can also be avoided as there would be no transfer of value. What is more, 100% Business Property Relief is available on small minority holdings in private trading companies.

However, income tax liabilities may arise, for example because there will be a cessation of the business.

STRUCTURING SHAREHOLDINGS

Level of Control

In a typical owner-managed company, the proprietor will hold the majority of the issued share capital. The current 100% IHT (BPR) exemption on private company shareholdings means that it is usually advisable to retain the shares. This will allow the owner to claim the exemption on death and also to benefit from the tax-free uplift in value for CGT purposes. But IHT saving should not be the only consideration here. If, say, the proprietor's children are actively involved in the business, it may be necessary to give them some shares to motivate them and reward their contribution to the increase in the company's value created by their efforts. This is important in assisting with the succession planning process.

The proprietors can retain absolute control of the company by holding at least 75% of the voting rights. This will enable them to pass special resolutions, sell the business, vary the company's constitution and put it into liquidation. For effective day-to-day control, such as the appointment and removal of directors and determination of remuneration and dividend policy, it is only necessary to hold over 50% of the shares.

If, however, the proprietor intends to build up the company for a future sale or flotation, then he should ensure that he has sufficient shares to achieve the desired share of the future sale proceeds.

Alternative corporate structures

Where an SME has diversified and operates a number of different trades or activities, it needs to opt for the most suitable corporate structure, by reviewing its legal structures on an ongoing basis. In doing so, it will take into account the objectives of the major shareholders, including exit planning and taper relief considerations, as well as commercial factors such as risk management.

There are three main legal corporate structures available, each with its own commercial and tax implications:

Single divisionalised company

Various trading activities are carried on through a single company, usually operating as a number of separate divisions or branches. Streamlining in this way should bring administrative cost savings. High-risk businesses should usually be excluded from the divisionalised company and retained in a separate subsidiary company. This prevents the assets of the divisionalised company being exposed to potential claims from creditors of the high-risk business in the event of its collapse.

The Substantial Shareholdings Exemption (SSE), introduced in 2002, places divisionalised structures at a tax disadvantage compared with a typical corporate group structure. The sale of a profitable trading division is likely to attract capital gains tax on the sale of goodwill and so on, whereas if the trade had been carried on through a separate subsidiary company, the gain would generally be tax-free under the SSE. It is more tax efficient to hold within a separate subsidiary company any trades earmarked for sale.

Parallel company

Each trade is run through a separate company. The shareholdings in each reflect the management responsibility of the individual business. The separate companies could together be owned by a group of individuals. If one of the companies is sold off, the sale proceeds will be paid directly to the individual shareholders, who will normally be able to claim the higher rate of business taper relief. For post 5 April 2002 sales, this rises to a maximum of 75% reduction against capital gains after only two qualifying years.

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Direct ownership of the shares also gives the shareholders greater flexibility in mitigating their CGT liabilities, such as pre-sale dividend strips, potential emigration and EIS CGT deferral relief.

Corporate group

The individual shareholders usually own the shares in the parent company, which in turn will hold the shares in the various trading subsidiaries. The corporate group has operational tax advantages over the parallel company. Taking advantage of the various group tax reliefs enables the group to be treated as a single entity for tax purposes. The group can also dispose of its subsidiaries tax free under the SSE.

MANAGEMENT STRUCTURES

Separating ownership and management Trading through a corporate vehicle allows the founder members to easily divorce ownership from management, unlike a typical partnership structure where they are closely linked. Unless the company's articles provide otherwise, a member of a company has no right to participate in the day to day management of a company. This task is delegated to the directors of the company.

The only limitation laid down by the Companies Act is that a company is obliged to have a minimum of two officers, namely a director and a secretary. Otherwise, the company is entitled to lay down whichever procedures and limitations on its management it chooses, by incorporating the agreed rules in its articles of association and, if appropriate, a shareholder's agreement.

The articles of association would usually be drafted so as to give the company directors almost free reign to regulate how they manage the company, although certain major decisions (such as borrowings over a certain limit) may be reserved to the shareholders by special resolution. The directors are also usually permitted to appoint a chairman or managing director and directors to the board as a replacement, or additional directors, but these appointments are usually reviewed by the shareholders at the annual general meeting.

A partnership too may devise its own rules for management, by incorporating them into the partnership deed or by establishing them through a course of dealing. However, the presumption laid down by the Partnership Act (1890) is that when it comes to taking decisions, these are generally taken on a majority vote. Amending rules in the partnership agreement could be done by unanimous approval, but this can be cumbersome and partners are entitled to choose in their partnership agreement any required percentage for approval they wish.

On the other hand, shares in a limited company are generally more easily transferable than the interests in a partnership (, subject to any restrictions or rights of pre-emption in the articles of association). Assigning a partnership interest will usually involve the assignee in becoming a partner and, as such, incurring liability to third parties for future debts of the partnership. It is easier in practice to be a passive shareholder in a company or a member of an LLP. Companies and LLPs offer a more flexible management structure by allowing the proprietors to divorce the ownership from management, whereas these are more closely linked in a partnership structure.

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