

The widening income and capital gains tax divide



Experts in keeping
things simple



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Agenda

- | | | |
|--------|---|------------------|
| 1.30pm | Registration and refreshments | |
| 2.00pm | Opening Address | Laura Hutchinson |
| 2.10pm | Property investors – Fighting back against George Osborne | Michael Dawson |
| 2.40pm | Tax alchemy – what is possible? | Andrew Marr |
| 3.10pm | <i>Coffee Break</i> | |
| 3.35pm | Planning at the end of a company's useful life | Tom Minnikin |
| 4.05pm | Employee share structures – helping employees enjoy capital gains | Michelle Hogan |
| 4.35pm | Closing remarks and questions from the floor | Michael Dawson |
| 5.00pm | Drinks and discussion | |

Introduction



Experts in keeping
things simple



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Various tax rates from 6 April 2017

0%, 7.5%, 20%, 32.5%, 38.1%, 40%, 45%, 60%



- Compare to capital gains tax rates:

0%, 10%, 18%, 28%

- Capital gains –if only for the simplicity!

Taxation of dividends v salary from 2016-17

SALARY	Higher rate	Additional rate
Profit before tax	100,000	100,000
Deduction for gross salary + employer's NIC	<u>(100,000)</u>	<u>(100,000)</u>
Taxable profits	0	0
Corporation tax	0	0
Employers NIC (13.8%)	12,127	12,127
Gross salary paid to employee	87,873	87,873
Employees NIC (marginal rate 2%)	(1,757)	(1,757)
Income tax (40%/45%)	<u>(35,149)</u>	<u>(39,543)</u>
Net take home amount	<u>50,967</u>	<u>46,573</u>
Combined effective rate of tax	49.0%	53.4%

Taxation of dividends v salary from 2016-17

Extra £100,000 to be extracted:

DIVIDEND	Higher rate	Additional rate
Profit before tax	100,000	100,000
Corporation tax (20%)	<u>(20,000)</u>	<u>(20,000)</u>
Profits available for distribution	80,000	80,000
Income tax payable	£5K @ 0% = -	£5k @ 0% = -
Income tax payable	@ 32.5% = <u>(24,375)</u>	@ 38.1% = <u>(28,575)</u>
Net receipt	<u>55,625</u>	<u>51,425</u>
Effective rate of tax	44.4%	48.58%
Saving compared to paying salary	<u>4.6%</u>	<u>4.83%</u>

Tax efficient remuneration post 5 April 2016

- Rethink structure and remuneration
- New dividend rates (0%, 7.5%, 32.5%, 38.1%)
- Dividends still better
- Small salary for NI
- Interest-free loans - become interest bearing?

Tax planning for property investors



MICHAEL DAWSON

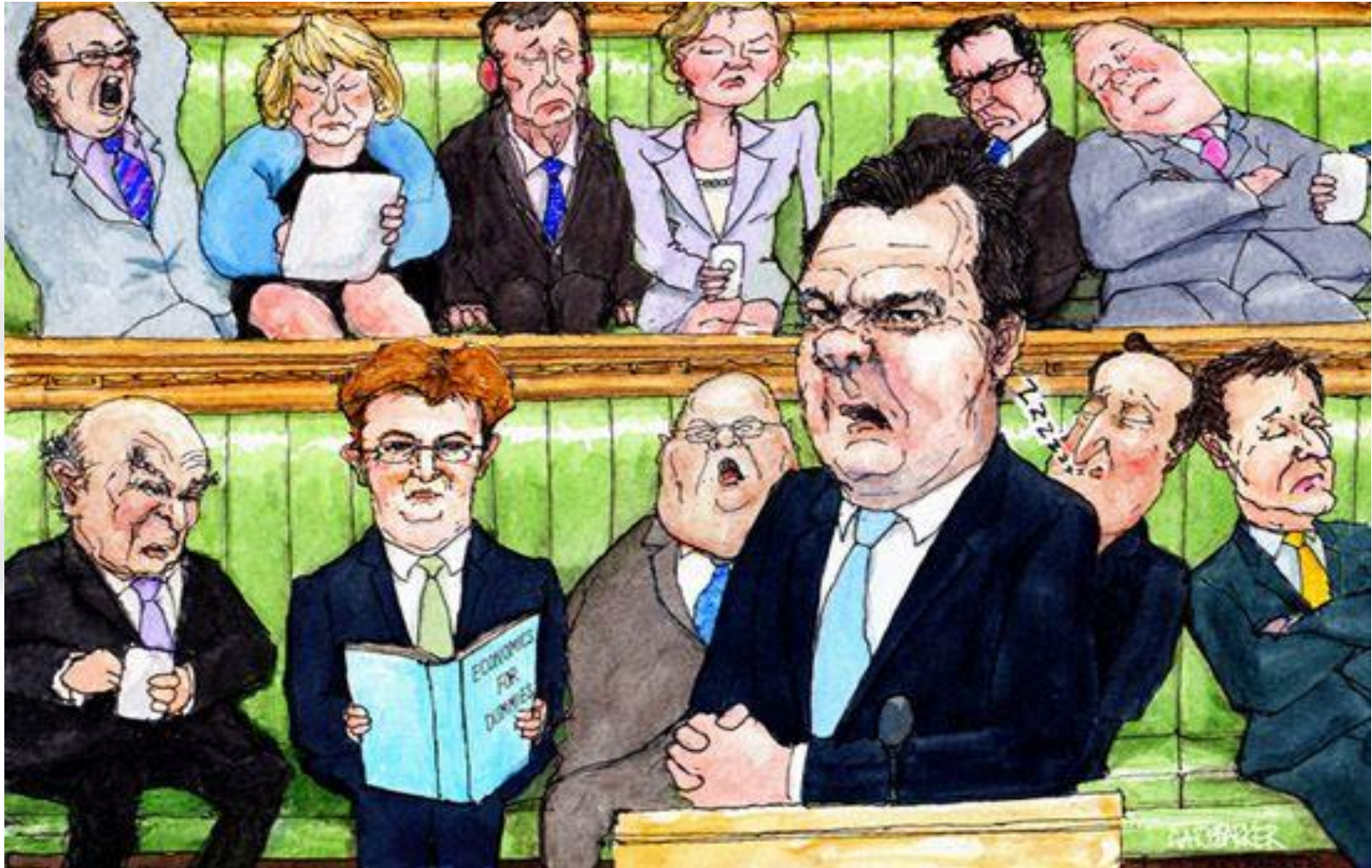
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Themes for today's presentation

- Recent tax changes for residential property
- Incorporation of property businesses
- Optimum property investment structures
- Using family investment company for inheritance tax planning



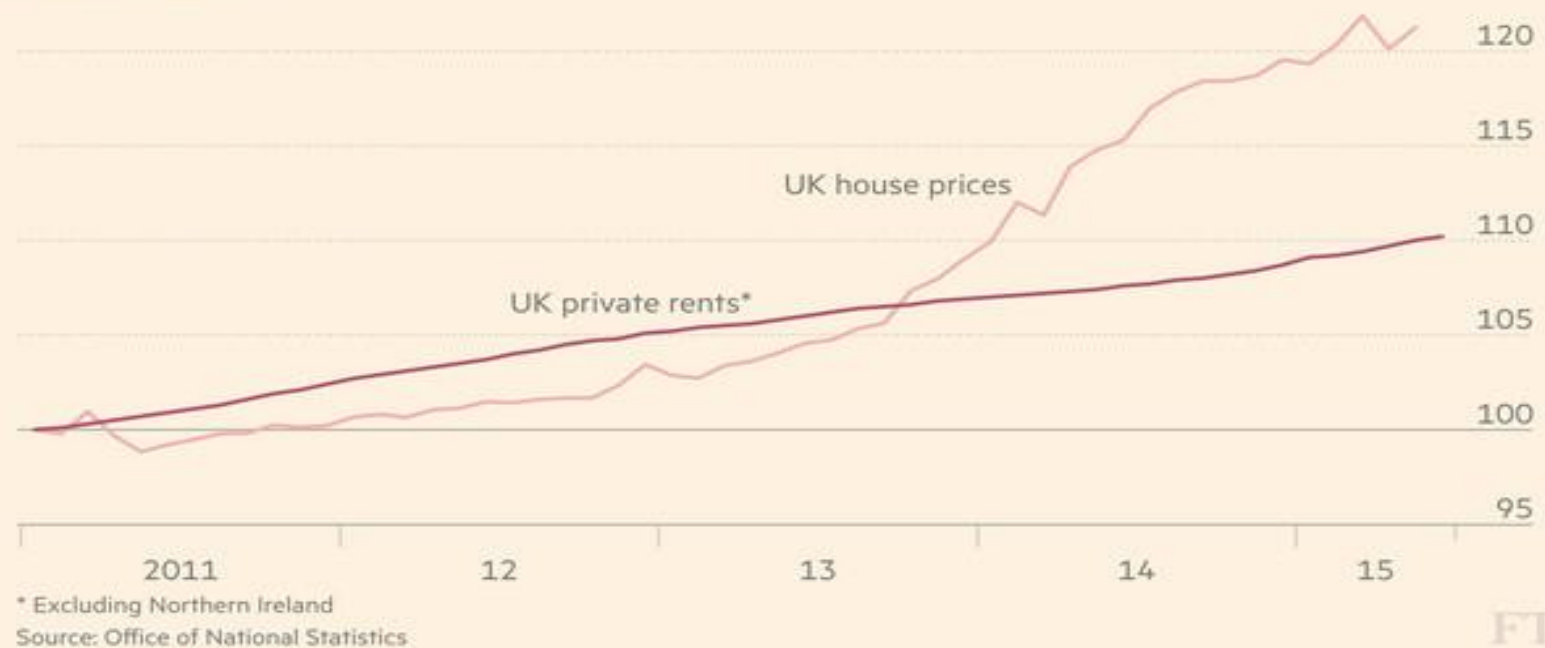
Government attack on residential property

- ATED (Annual Tax on Enveloped Dwellings)
 - Relevant to companies
 - Introduced 2013
 - Value reduced to £500K post April 2016
 - Various exemptions, but return must be filed
- Non resident capital gains tax – introduced 2015
- SDLT – marginal rate now up to 12% (property > £1.2M)
- Withdrawal of interest relief
- SDLT surcharge rate on new acquisitions post April 2016

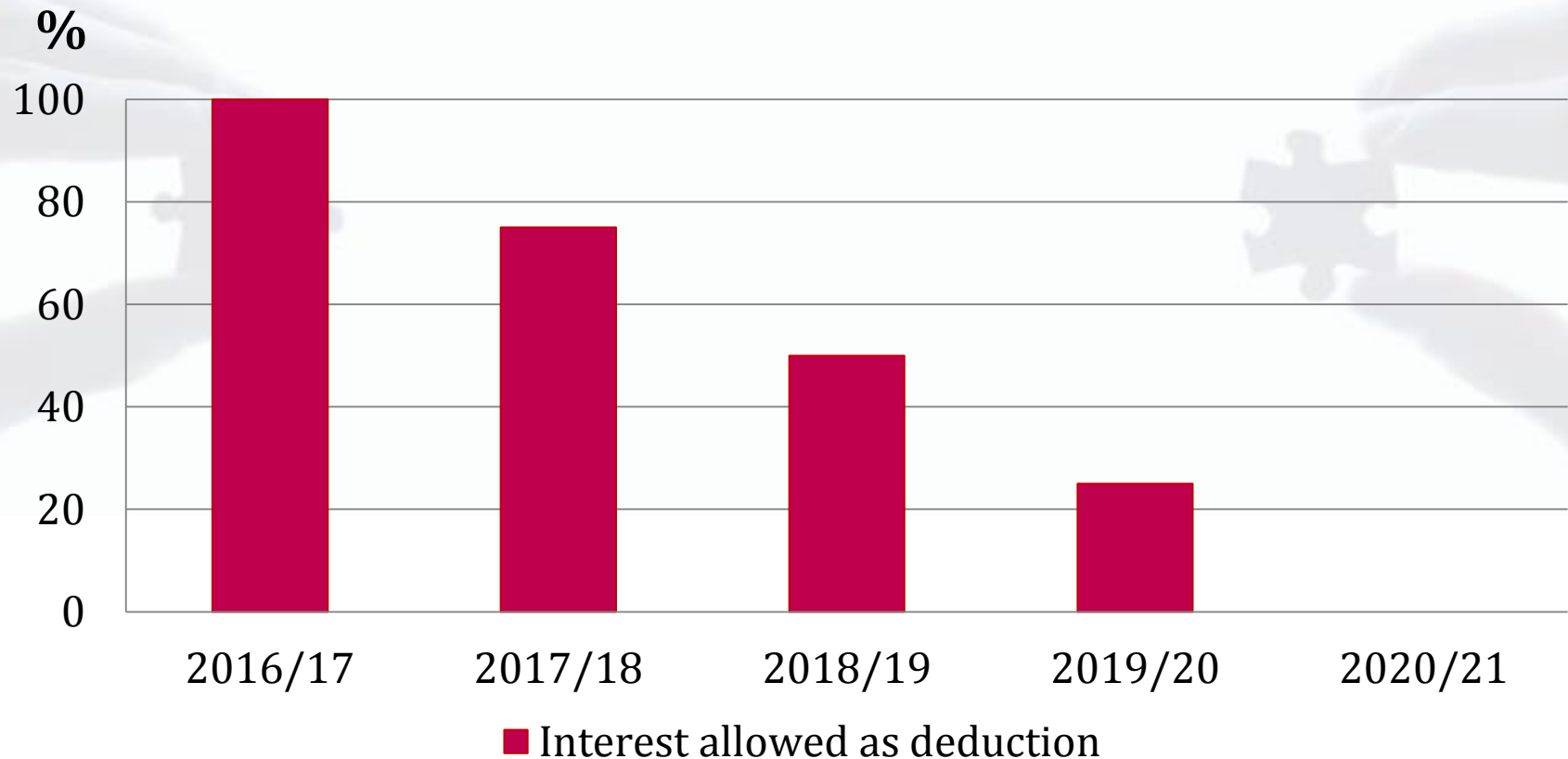
Reason for the attack

“Government’s view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidise it.” *Ronald Reagan*

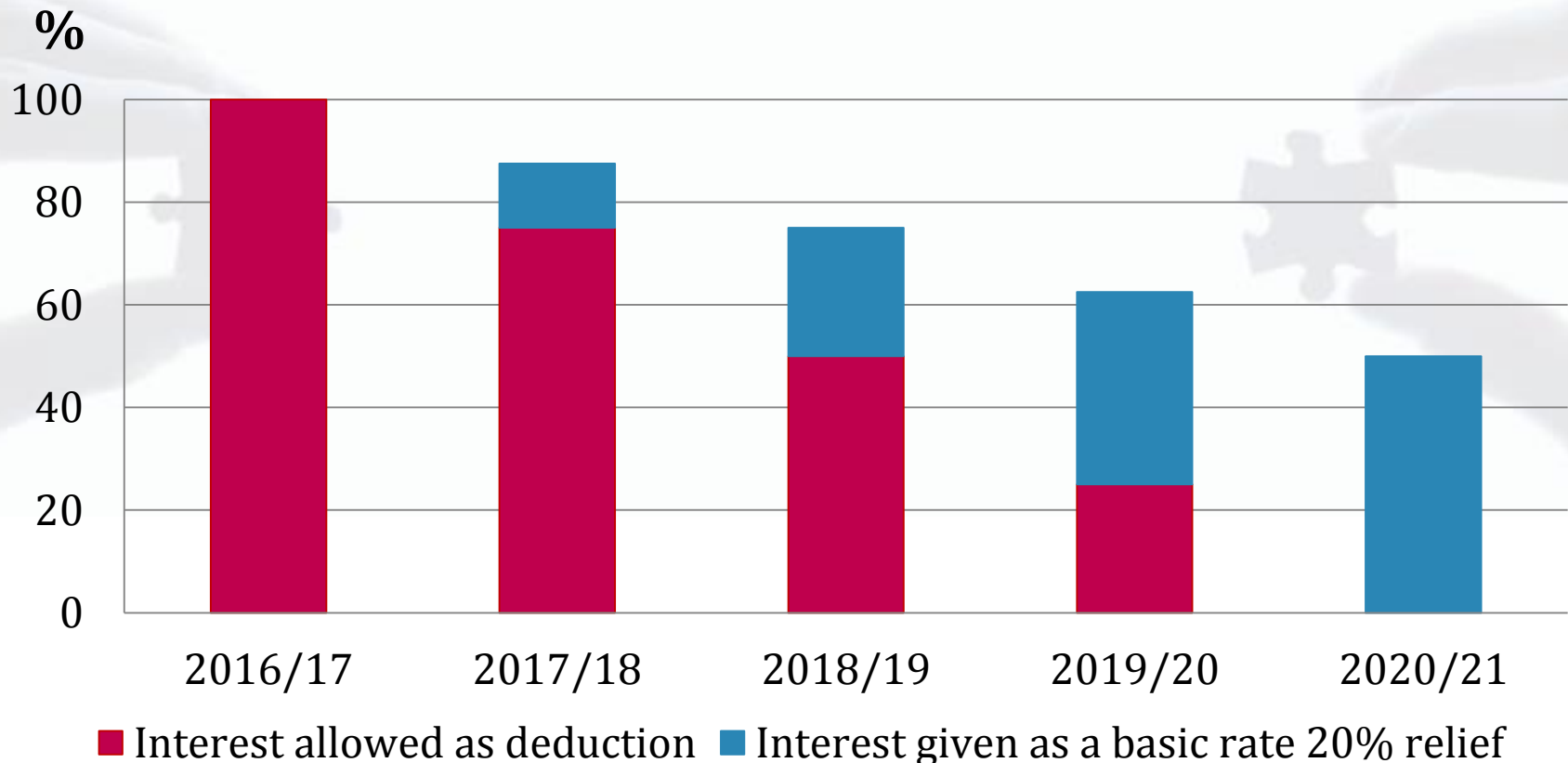
UK house prices and rents
Indices (rebased)



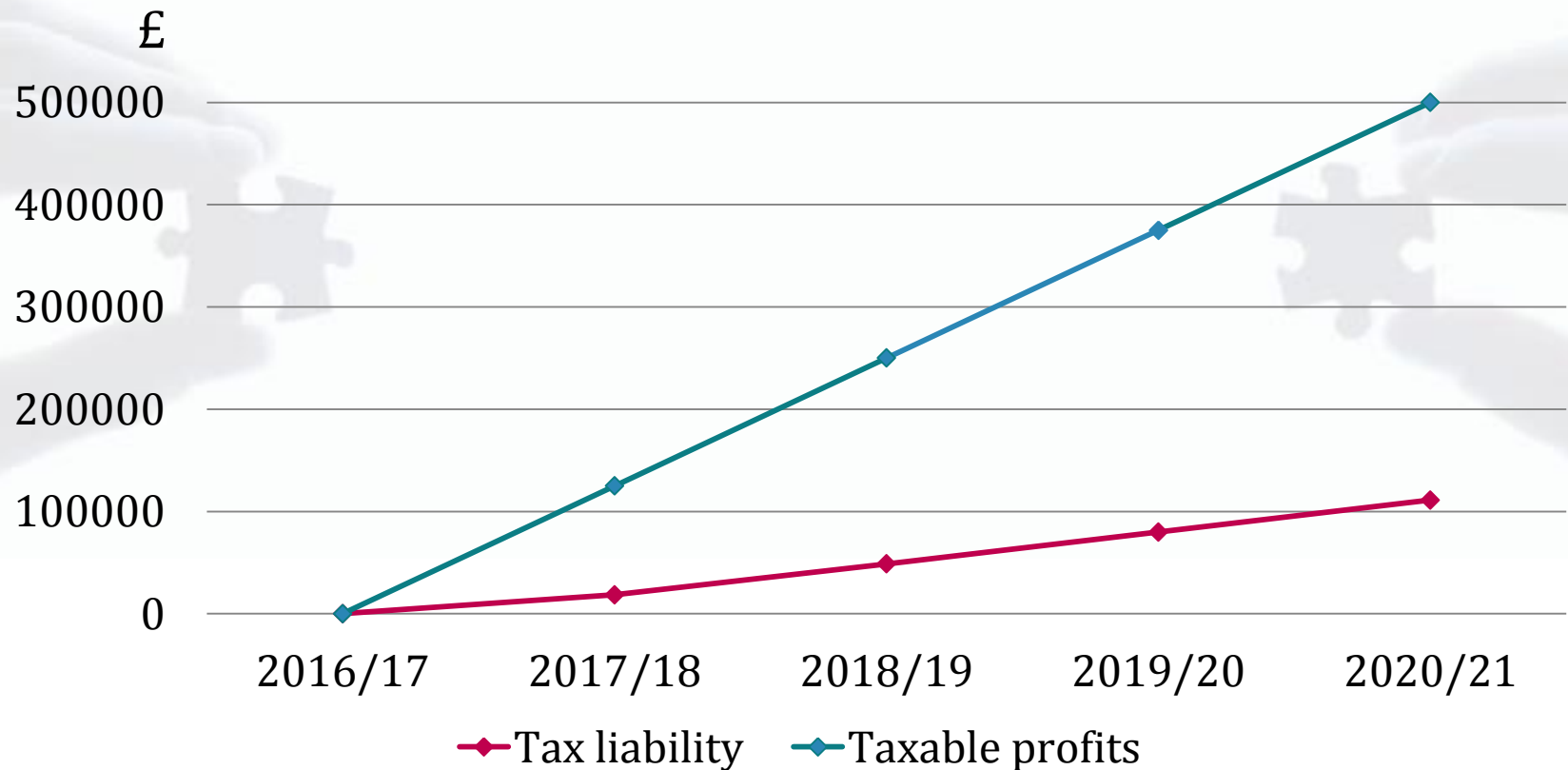
Effect of new interest restrictions on residential rentals - 40% taxpayer



Effect of new interest restrictions on residential rentals - 40% tax payer



Buy to let investor - £500K income and £500K interest



Options for highly geared buy to let investor

- Sell property
- Incorporate (companies get full interest relief)
- Use hybrid structure
- Offshore company?

Residential property – proposed SDLT rates from April 2016

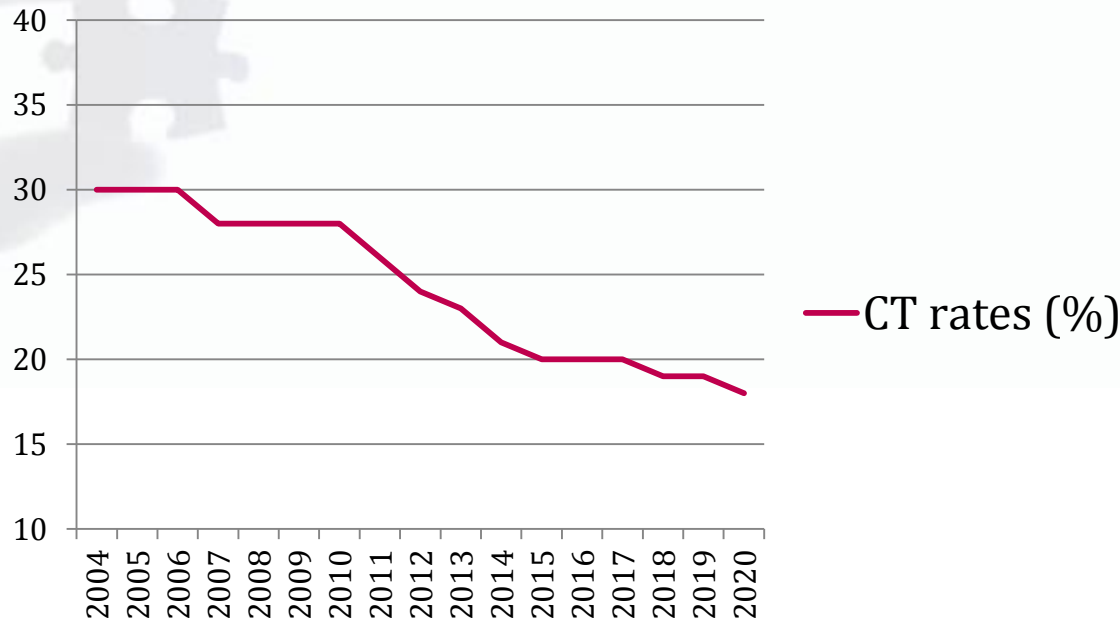
Property price	SDLT rate	SDLT surcharge rate
£	%	%
Up to £40,000	0	0
40,001 - 125,000	0	3
125,001 – 250,000	2	5
250,001 – 925,000	5	8
925,001 – 1.5M	10	13
1.5M plus	12	15

The benefit of lower corporation tax rates

- Individual = 45% income tax
- Company = 20% corporation tax

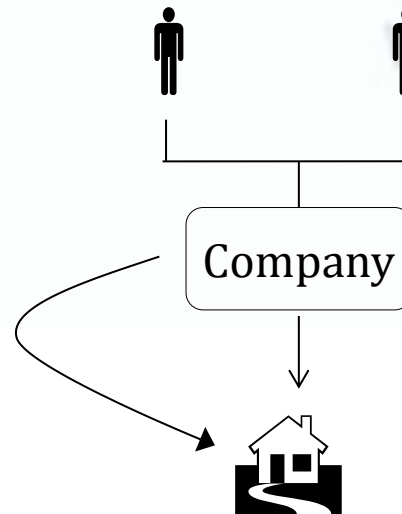
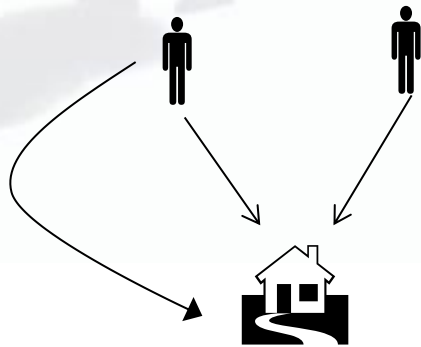
Example: £100,000
Individual (45%) = £45,000 tax
Company (20%) = £20,000 tax
Saving = £25,000

Decrease in CT rates (%)



Incorporation of property business

- Capital gains disposal
- Section 162 TCGA 1992 relief if in exchange for shares
- Uplift base cost of property to market value
- SDLT charge – subject to reliefs



ACT NOW BEFORE INCORPORATION RELIEF DISAPPEARS!

Personal tax on dividends – Current Year

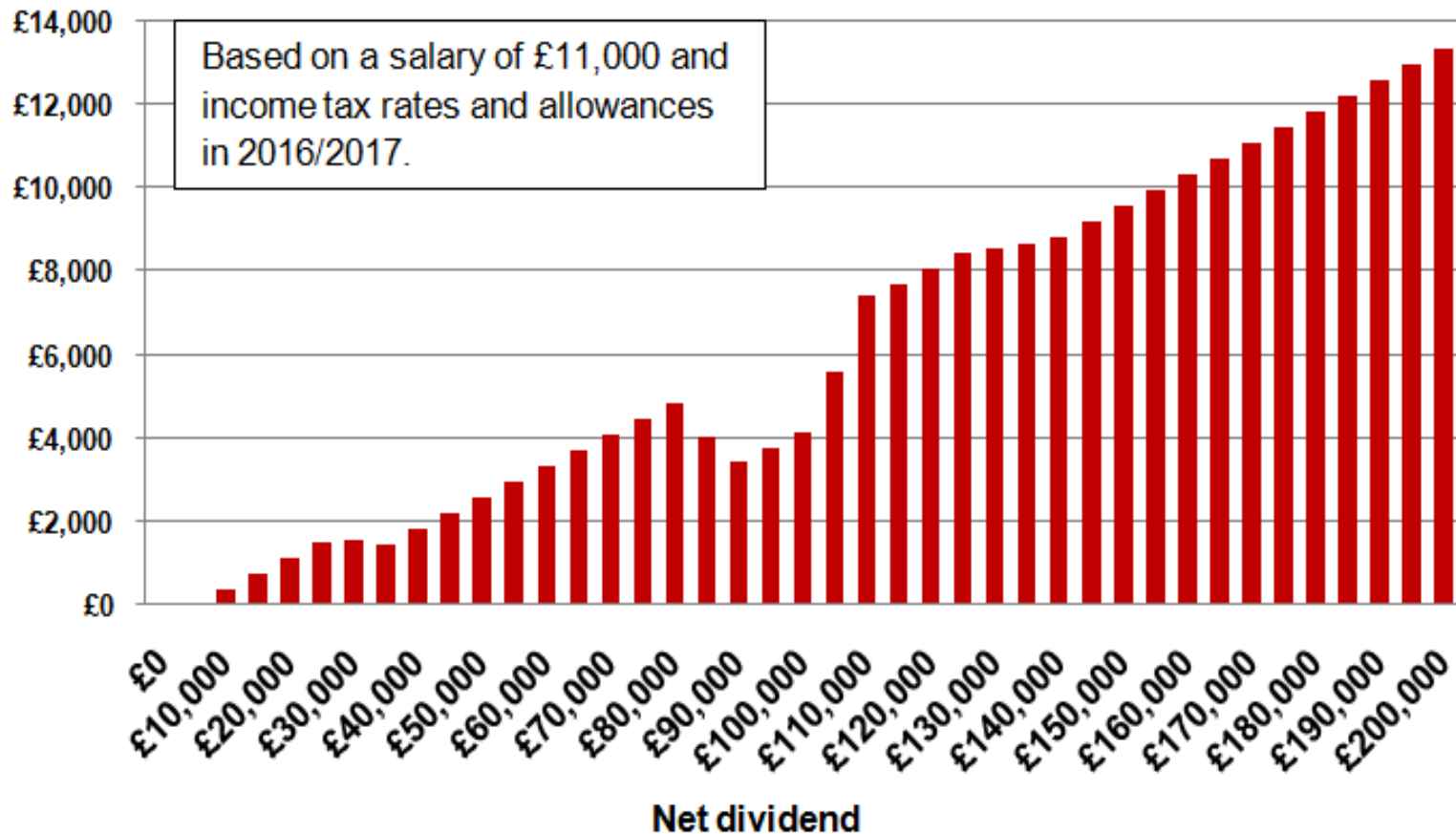
	Personal tax	Company tax	Total
Basic rate (20%)	Nil	20%	20%
Higher rate (40%)	25%	20%	40%
Additional rate (45%)	30.6%	20%	44.5%
Capital gains (28%)	28%	20%	42.4%

Personal tax on dividends – 2016/17

	Personal tax	Company tax	Total
Exemption	£5,000	20%	20%
Basic rate (20%)	7.5%	20%	26%
Higher rate (40%)	32.5%	20%	46%
Additional rate (45%)	38.1%	20%	50.48%
Capital gains (28%)	28%	20%	42.4%

Extra tax payable because of dividend rate rise

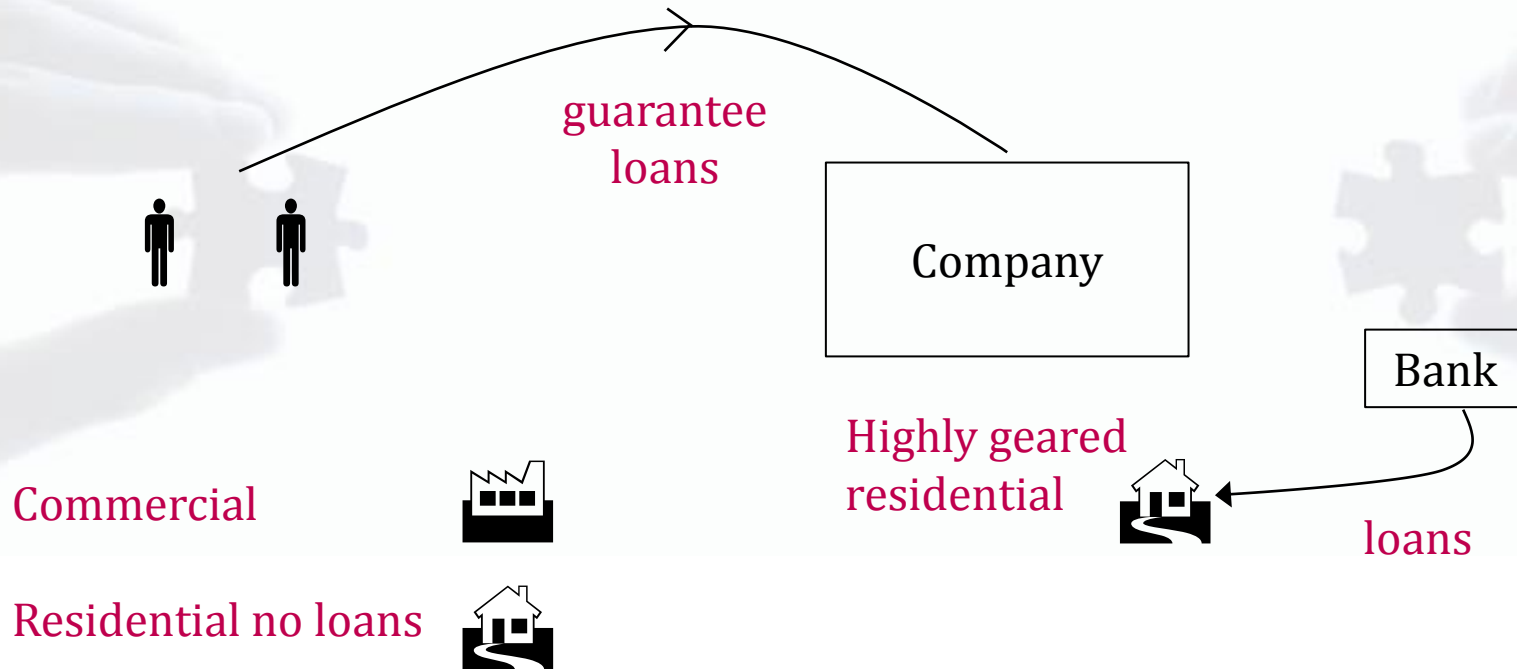
Additional tax payable



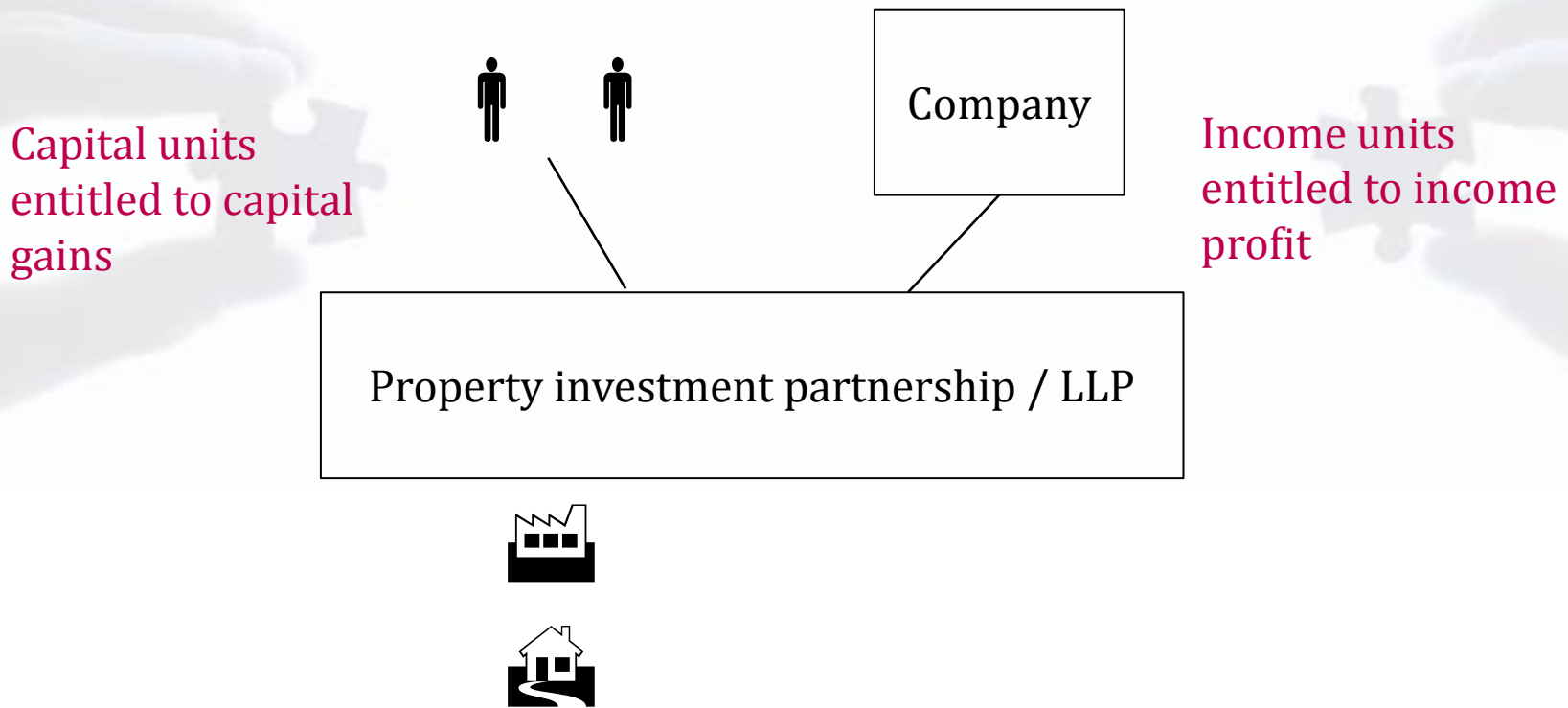
Choice for property investors

	Individual partnership	Company
Do you need income?	✓	
Do you have big equity in portfolio?		✓
Do you have big personal loan or share capital in existing company?		✓
Capital gains more important than income?	✓	

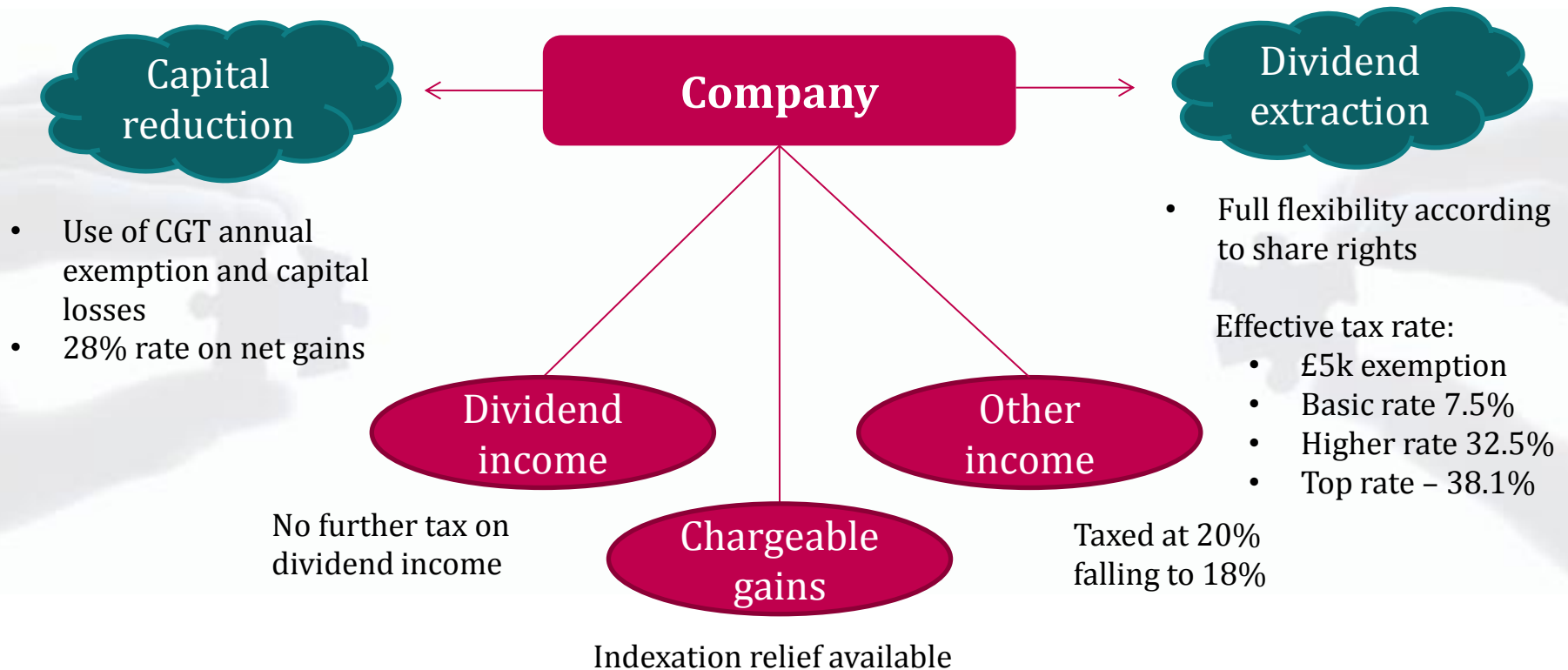
Hybrid structure 1 – linked partnership and company



Hybrid structure 2 - mixed partnership



IHT planning with family investment company



Holding investments in a company is efficient as the company has low corporation tax rates (20% and falling) and flexibility in distributing profits to shareholders.

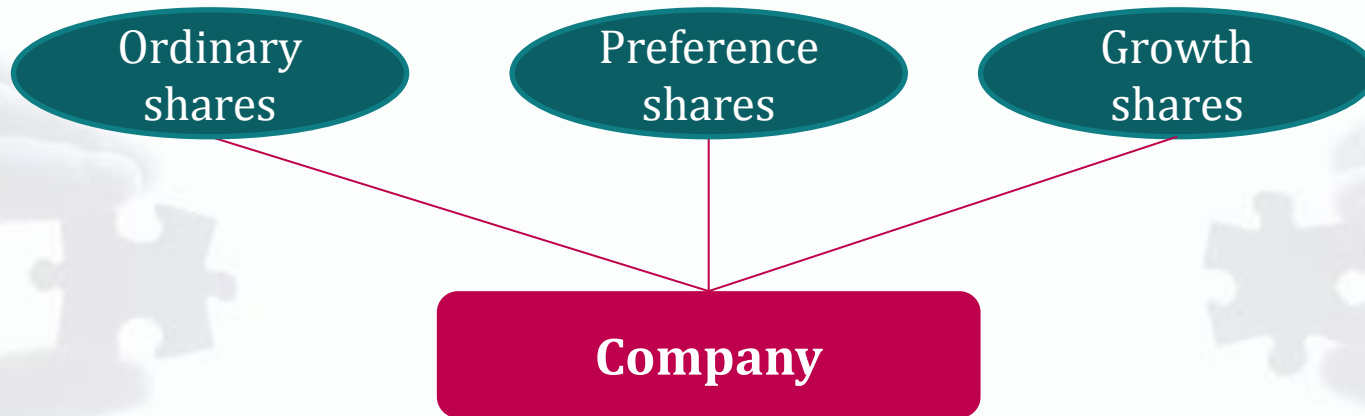
Property investment companies – inheritance tax planning

Advantages of companies and company shares:

- Minority shares valued at discount e.g.

Company net asset value	£10M
Total value of shares	£4M
- Shares are flexible
 - Voting rights
 - Dividend rights
 - Growth in value
- Directors can control without shareholder involvement

IHT planning with family investment company



For typical inheritance tax structure:

- Ordinary shares control the company – held in trust
- Preference shares retained to provide income for expected life
- Growth shares given away to reduce capital value of estate

Capital allowances – what can a client expect?

Post-integral features

Type of property	Main Pool (%)	Integral (%)	Total (%)
Care home	17.7	13.2	30.9
Commercial	3.6	29.8	33.3
Office space	4.6	6.2	10.8
Retail	7.0	29.3	36.3
School	10.4	8.3	18.7
Warehouse	9.9	12.1	22.0
Warehouse & office space	10.3	8.1	18.4
Church	20.1	8.5	28.6
Grand Total	9.1	17.3	26.4

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Tax alchemy



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Tax alchemy – what is possible?



Overview

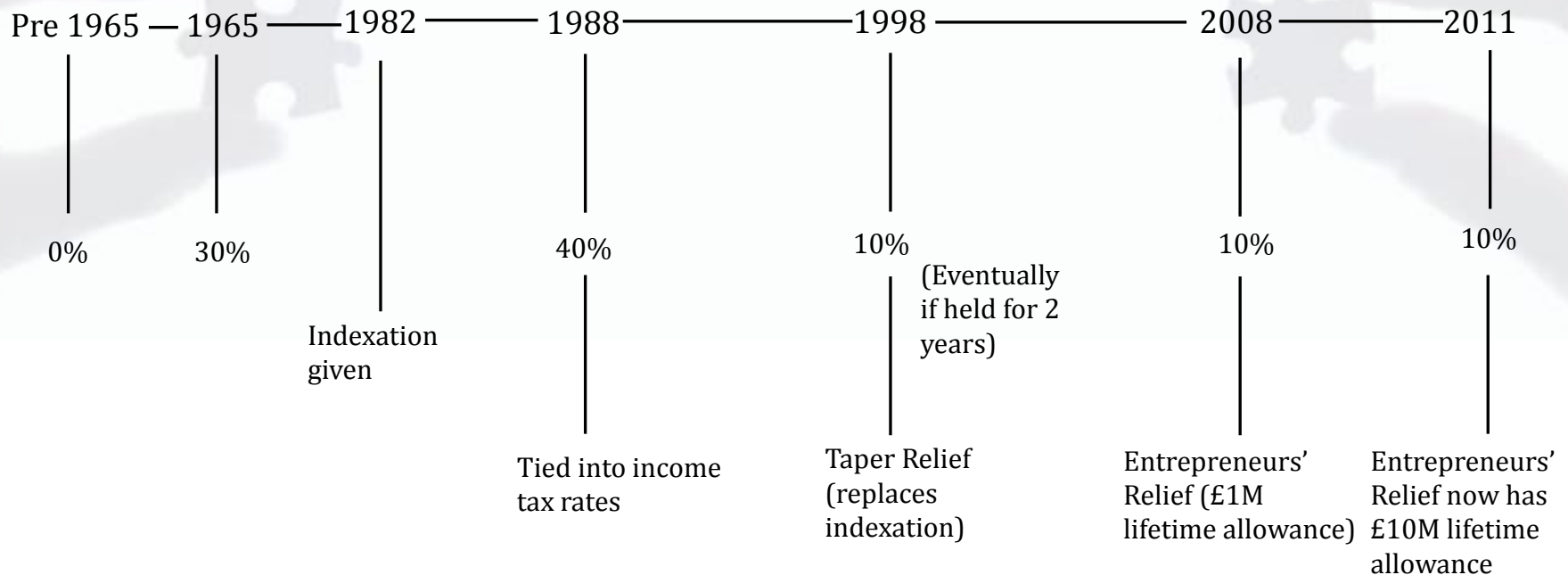
- The capital gains tax/income tax divide
- Transactions in securities legislation – HMRC’s defence
- Turning income into capital
- Turning ‘bad’ capital into ‘good’ capital (capital gains tax)
- Turning ‘bad’ capital into ‘good’ capital (inheritance tax)
- Clouds on the horizon – Autumn Statement

Capital gains tax / income tax divide

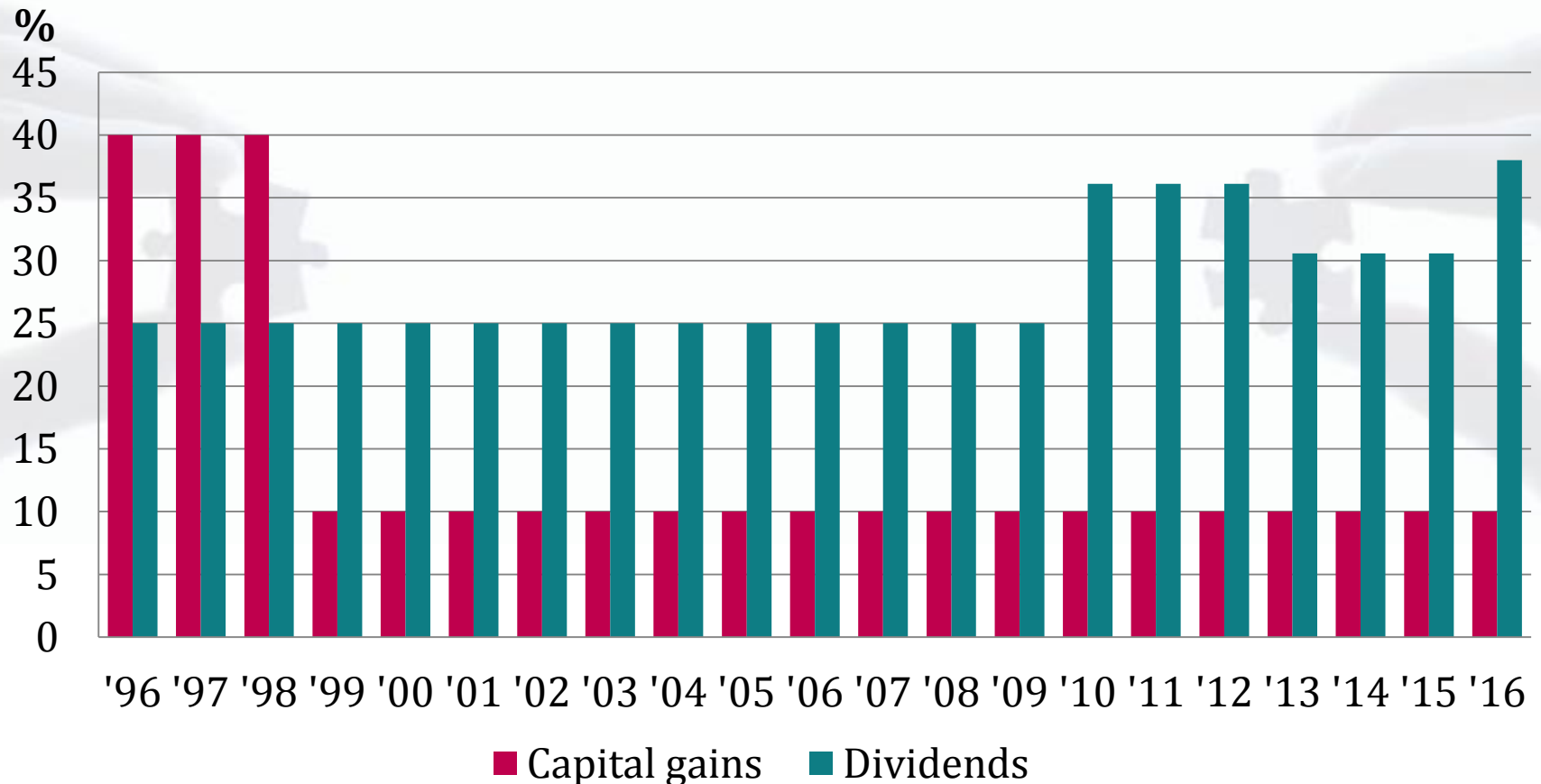
- A return to pre-1965 when no capital gains tax?
- Currently 30.56% income tax v 10% capital gains tax (with Entrepreneurs' Relief)
- Post 5 April 2016 will be 38.1% income tax v 10% capital gains tax (with Entrepreneurs' Relief) (28.1% difference)
- Massive incentive

Capital gains tax / income tax divide

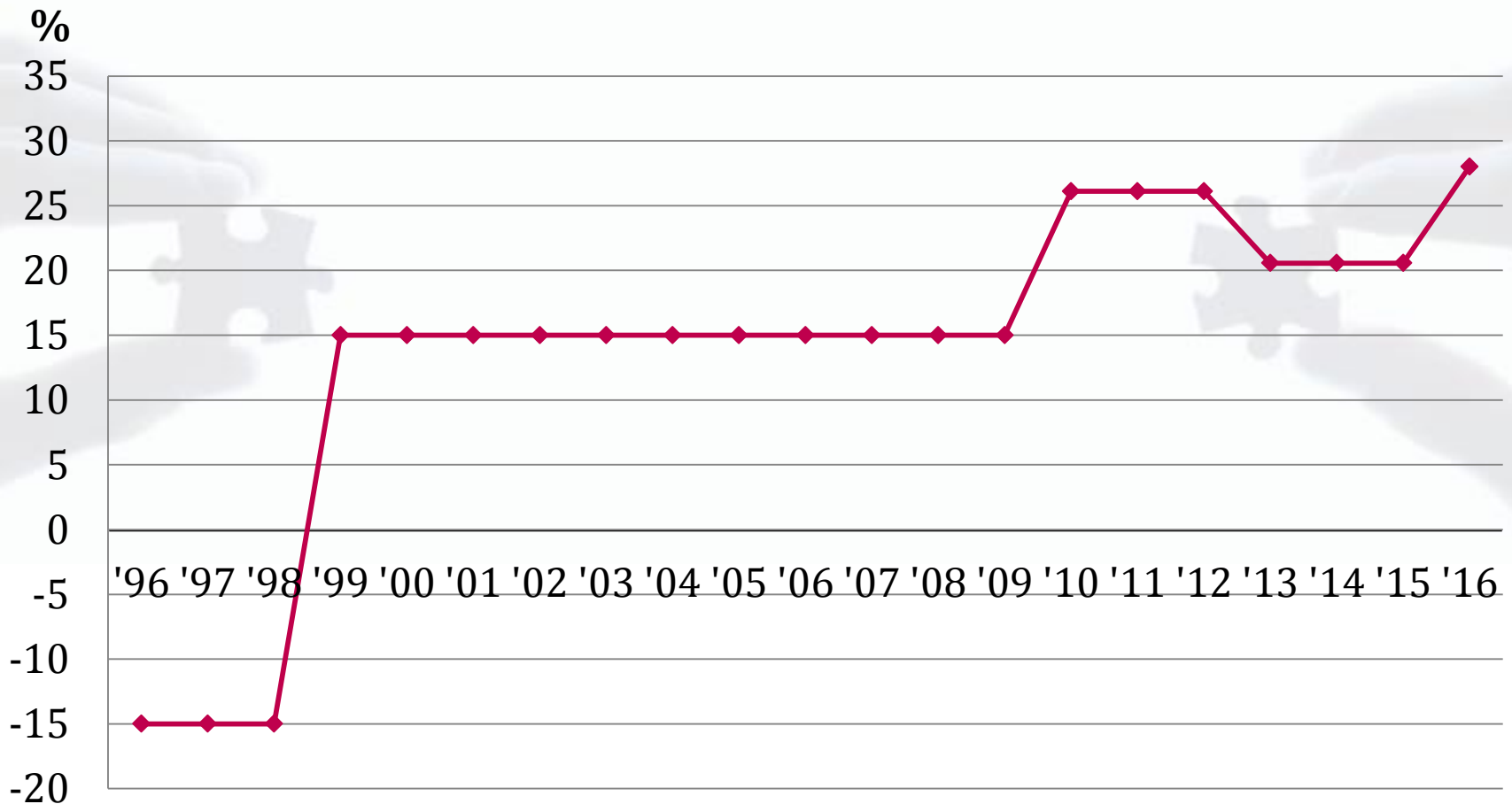
Capital gains tax timeline (assuming Entrepreneurial Reliefs)



Historical differences between additional rate tax on dividends and higher rate capital gains tax (assuming business relief where appropriate)



Historical differences between additional rate tax on dividends and higher rate capital gains tax (assuming business relief where appropriate)



Transactions in securities legislation – HMRC’s defence

- Fairly complex legislation
- HMRC can counteract by taxing capital and income
- Various conditions
- Counteraction means taxpayer has to pay the difference between income tax and capital gains tax
- But good news

Transactions in securities legislation – HMRC's defence

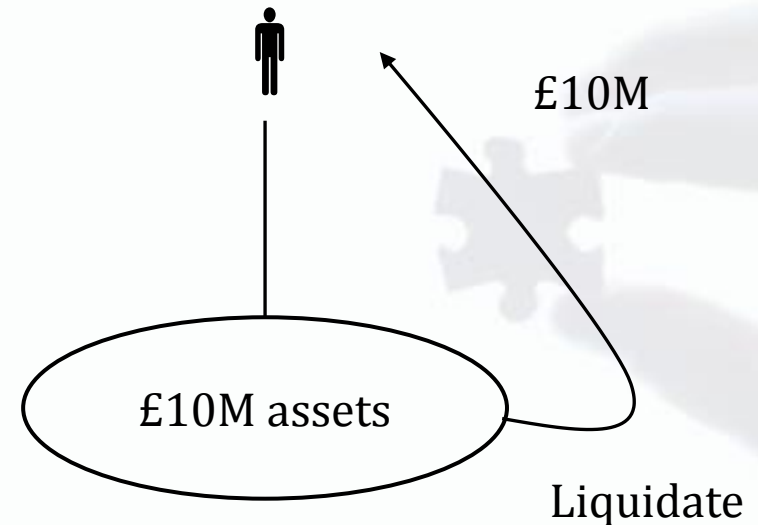
Fundamental change in ownership exemption

- Section 686 ITA 2007
- There is a fundamental change of ownership if
 - 75% of company owned by another person (unconnected)
 - Entitlement to at least 75% of distributions
 - Entitlement to 75% of votes

Turning income into capital

1. The simple liquidation

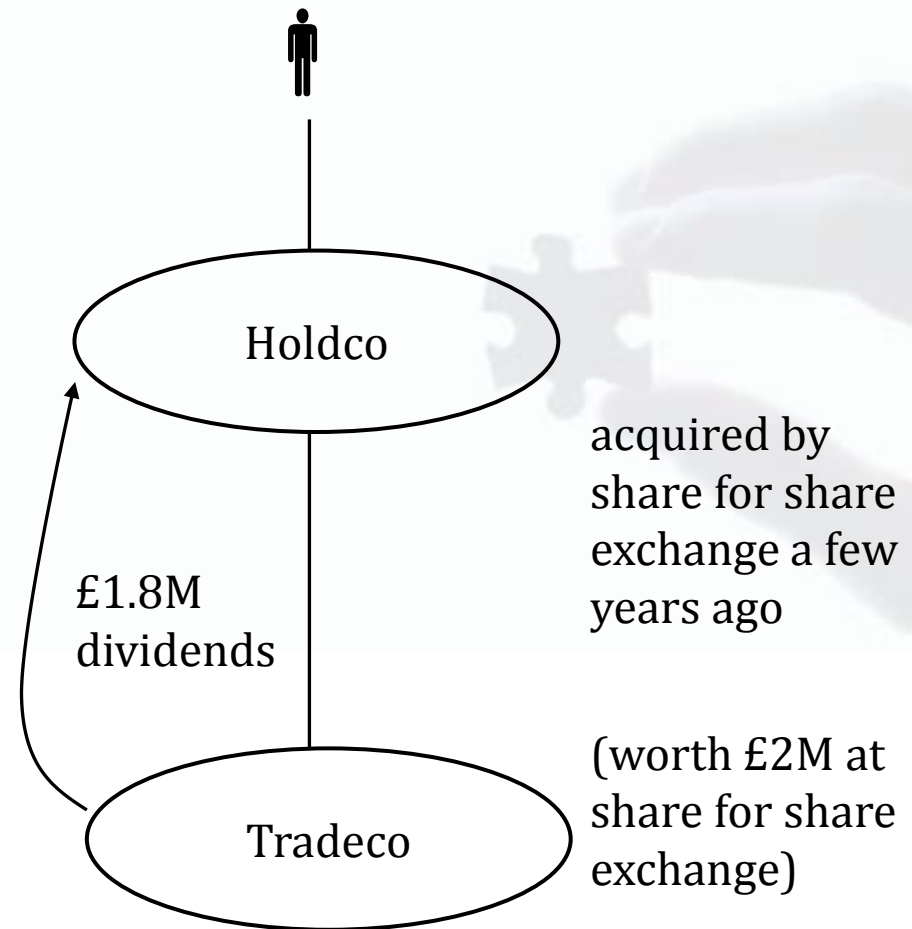
- £1m tax (10% rate)
- Little risk of transaction in securities legislation (but note phoenixing issues)
- Consider chargeable gains (taxed at 20% in company)



Turning income into capital

2. Company purchase of own shares

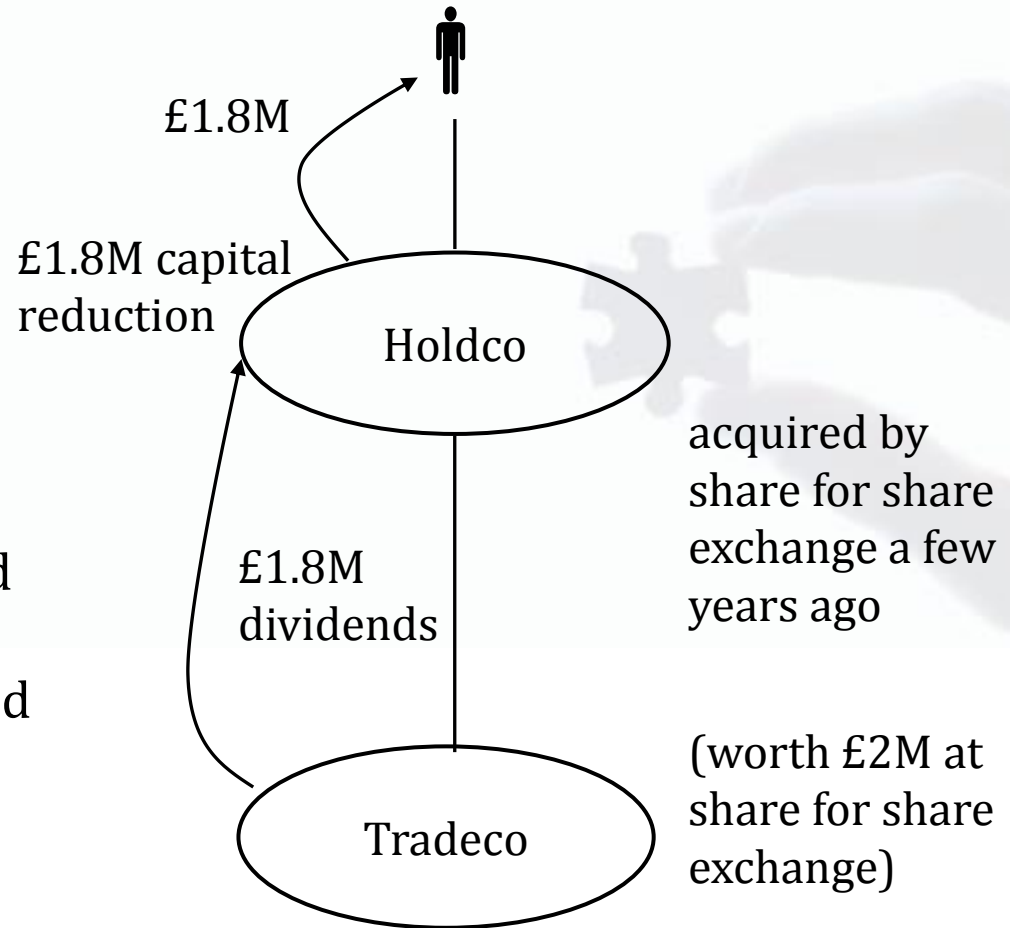
- 90% of shares bought back by company
- This is all capital (return of subscription)
- Do not need special capital treatment
- But transaction needs to be at market value
- 0.5% stamp duty charge
- Transaction in securities legislation – debatable but HMRC think it applies



Turning income into capital

3. Capital reduction

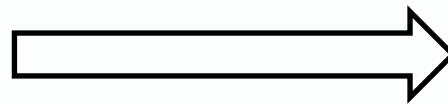
- Similar to company purchase of own shares
- No deemed market value
- No stamp duty
- Transaction in securities legislation – usually there is a strong technical defence based on ‘assets which are shown to represent a return of sums paid by subscribers’



Turning income into capital

3. Capital reduction – the merger relief issue

- ‘Merger relief’ provides a choice for share for share exchanges
- Either fair value or **nominal**
- If nominal then no capital
- Can we change in a later year?





Holdco balance sheet

	£
Investment in subsidiary	100
	<hr/>
	100
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Share capital	100
	<hr/>
	100
	<hr/>

Turning income into capital

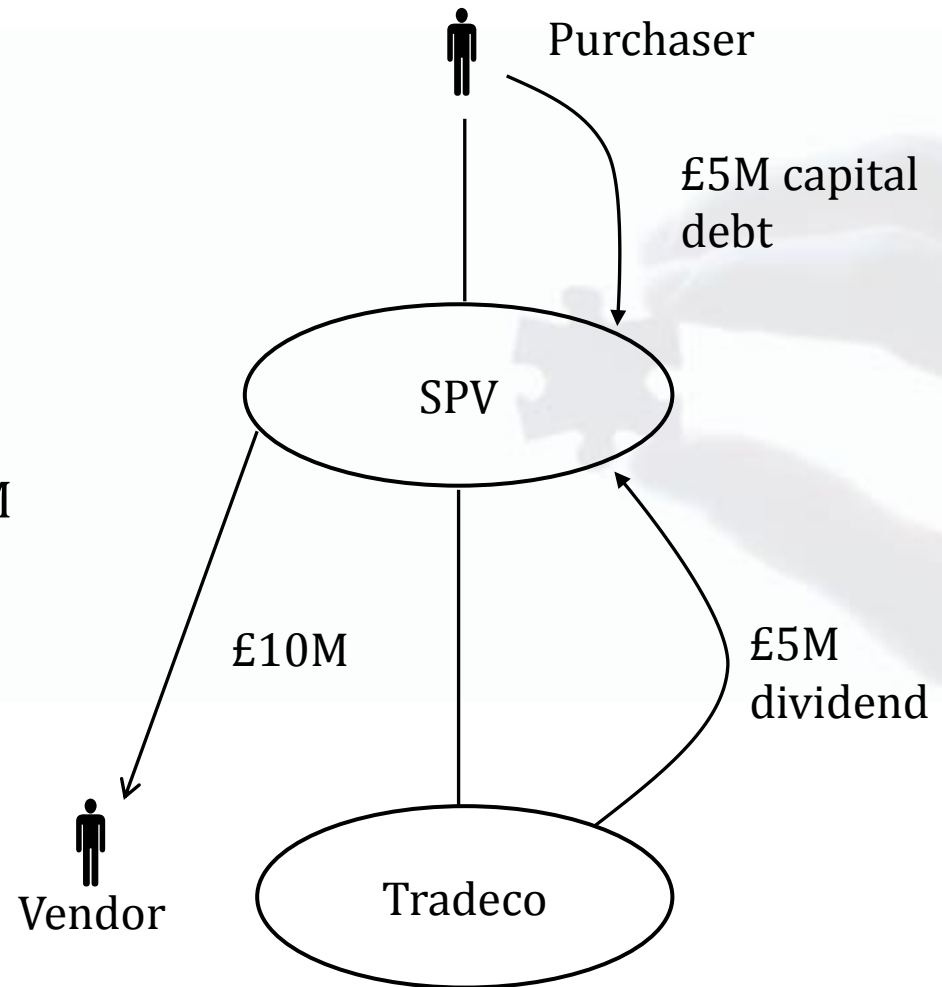
3. Capital reduction – the merger relief issue

	31 December 2012		During 2015
	£		£
Investment in subsidiary	100	Investment in subsidiary	100 + 1,999,900
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	100		2,000,000
	<hr style="width: 50px; margin-left: auto; margin-right: 0;"/>		
Share capital	100	Share capital	100
	<hr style="width: 50px; margin-left: auto; margin-right: 0;"/>		
	100	Merger reserve	1,999,900
	<hr style="width: 50px; margin-left: auto; margin-right: 0;"/>		<hr style="width: 50px; margin-left: auto; margin-right: 0;"/>
			2,000,000
		Bonus share issue to create capital	<div style="display: flex; align-items: center;"> <div style="margin-right: 10px;">  </div> <div style="text-align: right;"> <hr style="width: 50px; margin-left: auto; margin-right: 0;"/> </div> </div>
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		Capital reduction	

Turning income into capital

4. Sale (using excess cash)

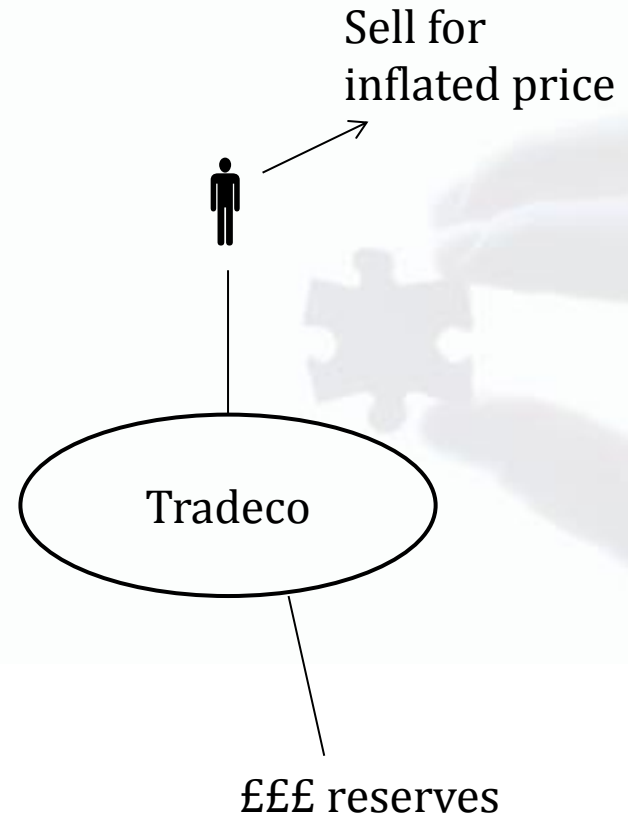
- Purchaser sets up SPV with £5M of capital and debt
- SPV purchases tradeco for £10M using £5M capital/ debt and £5M dividend
- Transaction in securities legislation No! – Fundamental change of ownership exemption



Turning income into capital

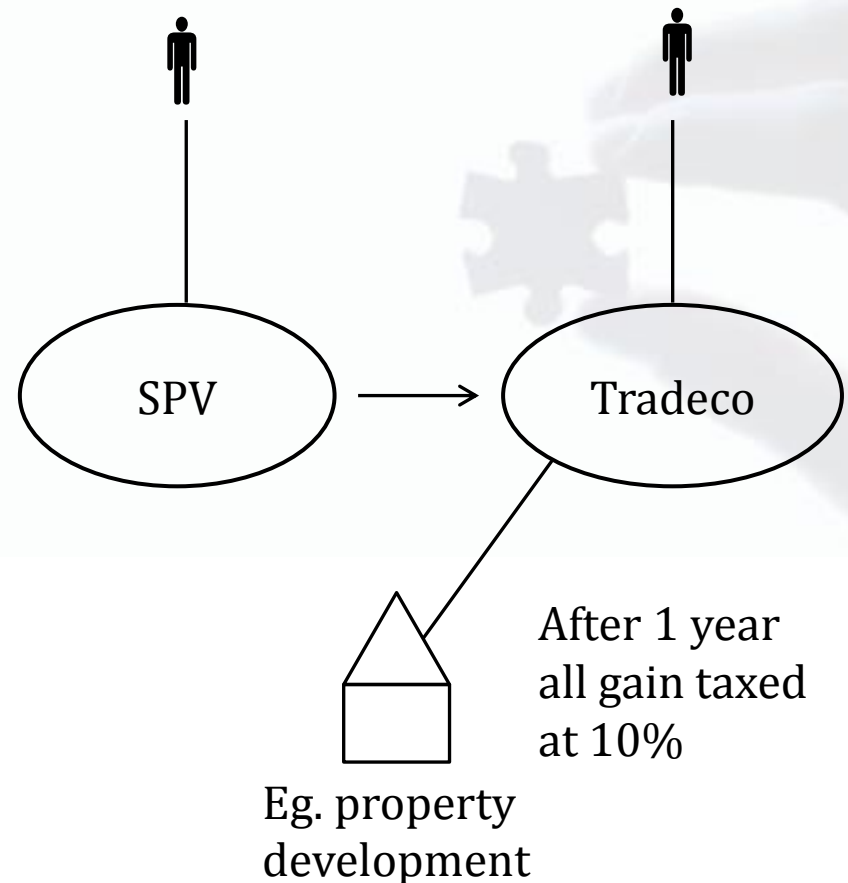
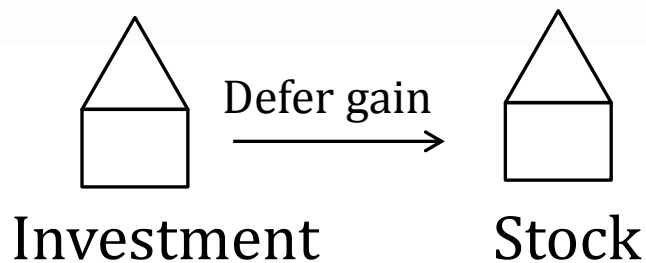
5. Let reserves build up and sell

- Risk of jeopardising Entrepreneurs' Relief
- But HMRC relaxed about 'inactive cash'
- Activities key
- Weigh this up against non-performing excess cash



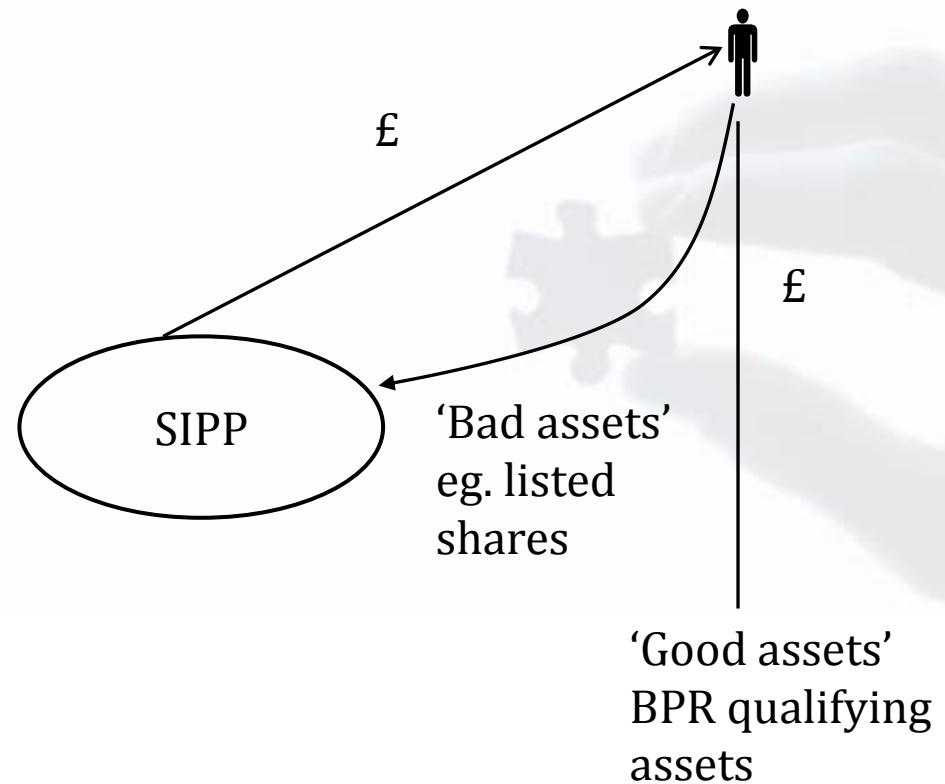
Turning 'bad' capital into 'good' capital (capital gains tax)

- Liquidate investment assets (possible tax charge)
- Run trade for a year
- Liquidate



Turning 'bad' capital into 'good' capital (inheritance tax)

- 'Converts' non-BPR assets into BPR assets
- 2 year ownership required (insurance?)
- SIPP outside of inheritance tax net anyway
- Buy shares off son???



Clouds on the horizon – Autumn Statement

‘To reduce opportunities for income to be converted to capital to gain a tax advantage, the Government will shortly publish a consultation on the company distributions rules and will amend the transactions in securities rules and introduce a targeted anti-avoidance Rule.’

Is the fun over?

Clouds on the horizon – Autumn Statement

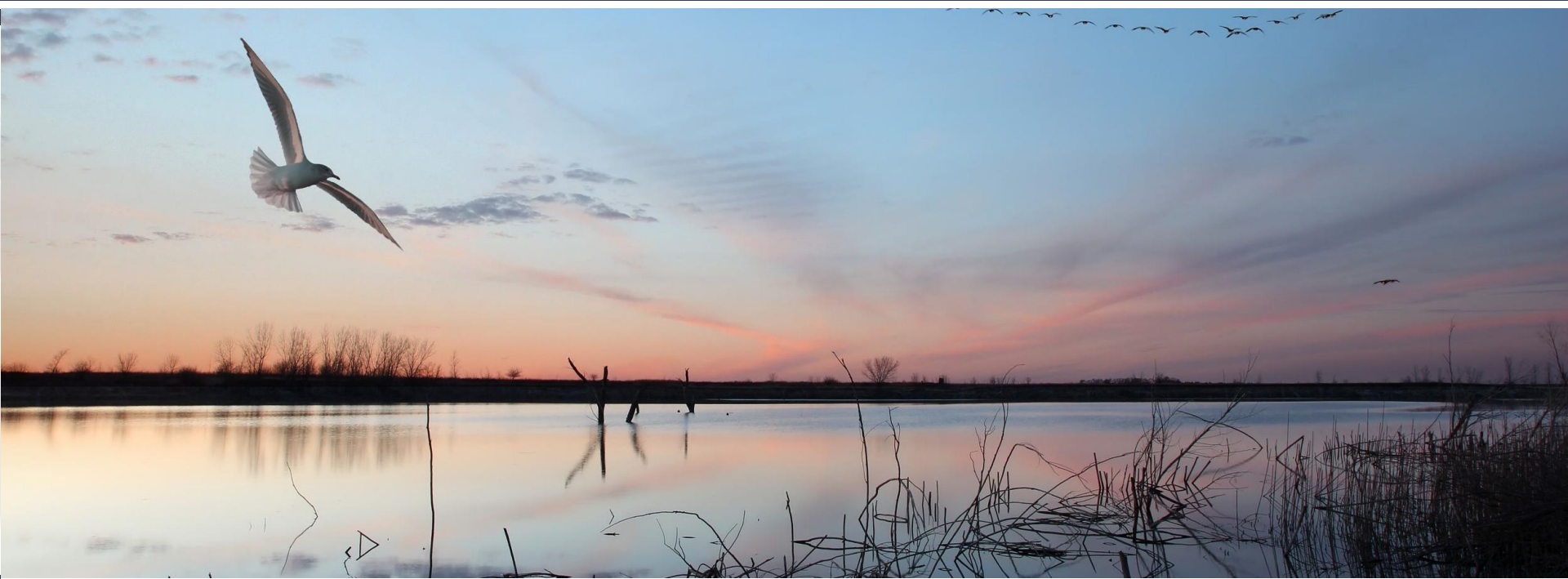
Speculation

- Certain liquidation proceeds to be taxed as distributions?
- Capital reductions as distributions – unless a return of cash subscription
- Make transaction in securities legislation subject to self-assessment?
- Do things before March 2016 Budget to be safe

Summary

- Tax alchemy is still possible
- Government tacitly agrees with this – given clues in the Autumn Statement
- Take advantage of opportunities before it is too late

Planning at the end of a company's useful life



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Planning at the end of a company's useful life

- Objectives:
 - Investor reliefs: Entrepreneurs' Relief, EIS, SEIS etc.
 - Corporate reliefs: substantial shareholdings exemption ('SSE')
- Strategies:
 - Pre-cessation planning
 - Liquidation planning
 - Re-organisation
- Issues:
 - Phoenixing / transactions in securities
 - Obtaining clearance

Case study: Pharmacy business

- Scenario:
 - Company sold business for circa £3.5 million in 2015.
 - Wide class of shareholders:
 - Some with Entrepreneurs' Relief
 - Mixture of high/low incomes
 - Different time horizons on when money required
 - Warranty/indemnity period preventing immediate liquidation

Dividend vs capital distribution

Tax rates prior to 6 April 2016

	Income Distribution (dividends) / £	Capital distribution (liquidation) / £
Basic rate taxpayer	0%	18%
Higher rate taxpayer	25%	28%
Additional rate taxpayer	30.55%	28%
Entrepreneurs' Relief (ER)		10%
Employee Shareholder Status (ESS)		0%
Enterprise Investment Scheme (EIS)		0%
Tax free allowance	£10,600	£11,100

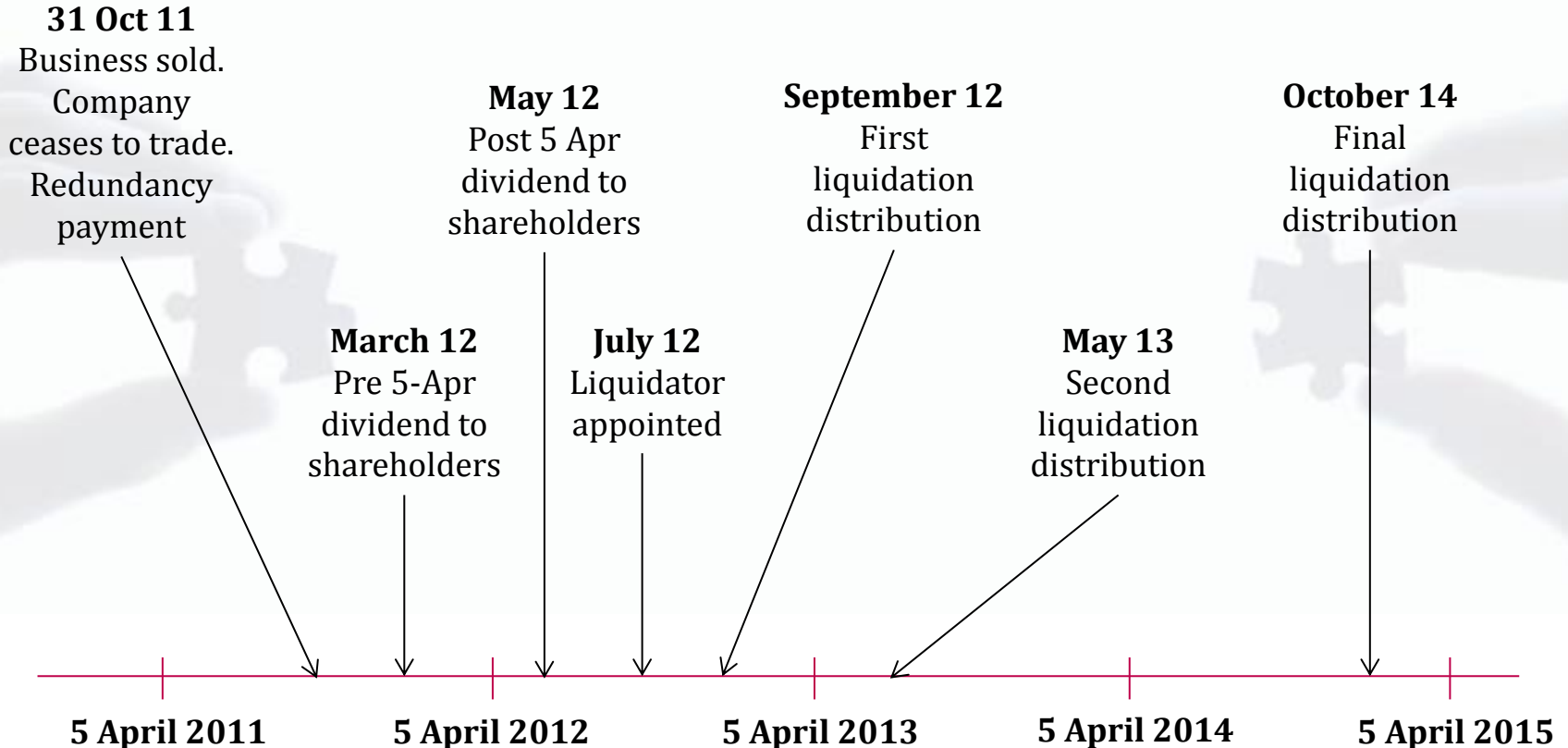
Dividend vs capital distribution

Tax rates from 6 April 2016 onwards

	Income £	Capital £
Basic rate taxpayer	7.5%	18%
Higher rate taxpayer	32.5%	28%
Additional rate taxpayer	38.1%	28%
Entrepreneurs' Relief (ER)		10%
Employee Shareholder Status (ESS)		0%
Enterprise Investment Scheme (EIS)		0%
Tax free allowance	£10,800	£11,100

NB: Special £5,000 tax free dividend allowance introduced with effect from 6 April 2016.

Case study: Pharmacy business



Pre-liquidation planning

- Consider differential share classes
- Income tax planning:
 - Payments to shareholders with unutilised personal allowances or basic rate bands will often be more tax efficient
 - £5,000 tax free dividend allowance from April 2016
- Capital gains tax planning:
 - Make full use of annual exemptions where possible
 - Ensure distributions are made within 3 years of trade ceasing for ER
- Spousal income splitting
- Termination payments
- Pension contributions

Obtaining capital treatment

Position prior to 1 March 2012:

- HMRC would, by concession, agree to treat a distribution made prior to a dissolution (informal striking off) as a capital payment
- Required advance assurance, with a declaration of solvency from the directors

Obtaining capital treatment

Position from 1 April 2012 onwards:

- ESC C16 replaced with a statutory rule (s 1030A CTA 2010)
- Distributions made in contemplation of a dissolution taxed as capital if:
 - Company has or intends to collect all debts and pay all creditors
 - The amount of the distribution(s) does not exceed £25,000
- Requires company to be finally struck off within 2 years

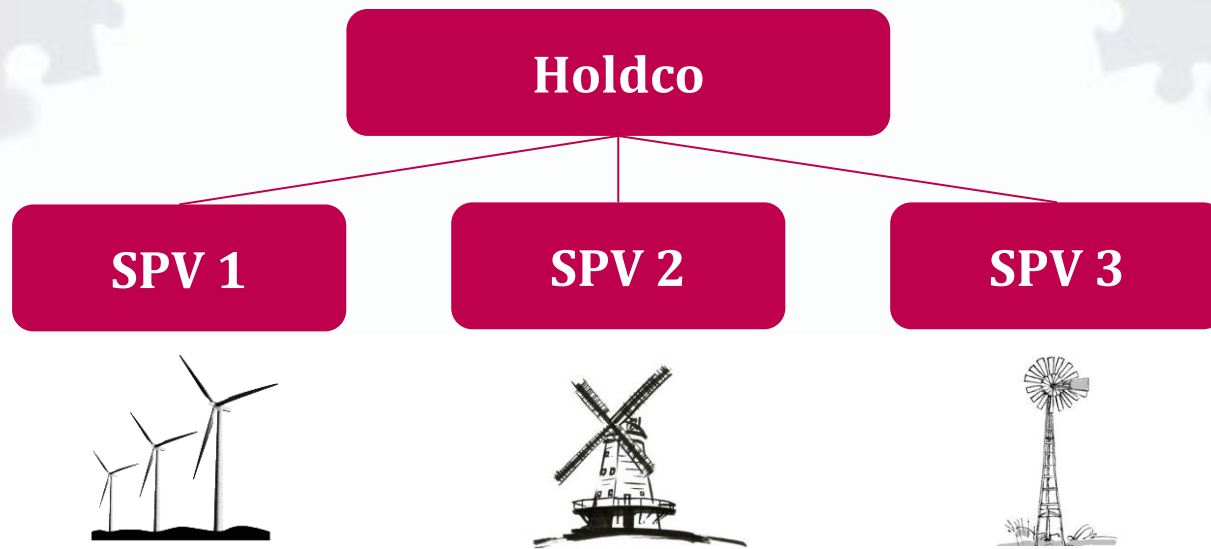
Companies with net assets of more than £25,000 will be forced to go down the formal Members Voluntary Liquidation (MVL) route

Phoenixing

- Issue: potential for HMRC to treat capital distribution as income.
- Is a liquidation in itself a transaction in securities?
- Will this change as a result of the Autumn Statement?
- Risk of attack if trade continues after the winding-up
- Liquidation needs to be commercially driven
- Care required in relation to trading status if company has built up profits.

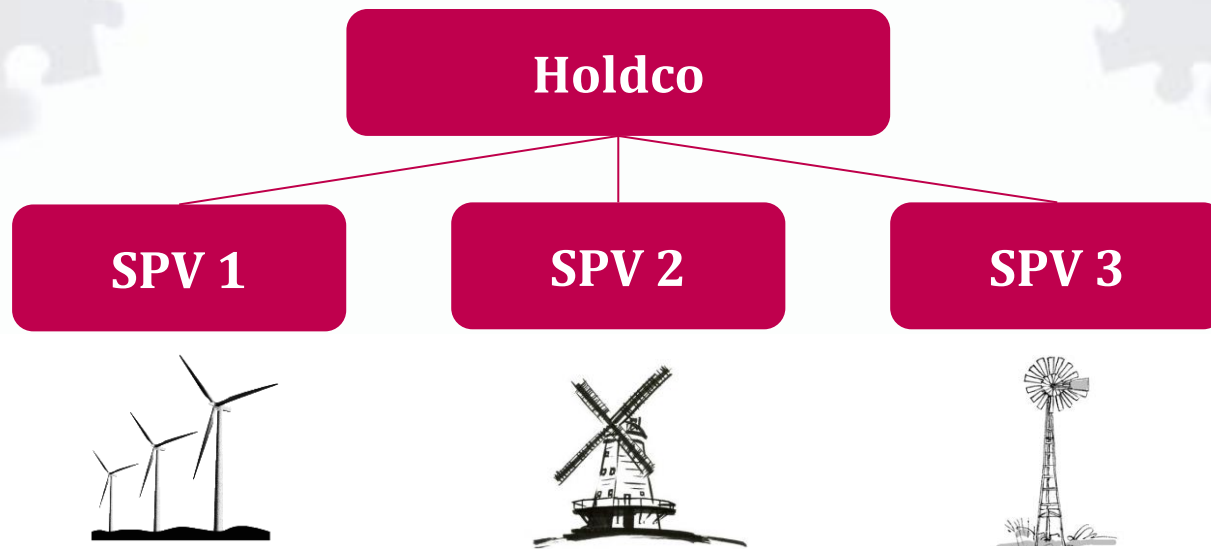
Case study: Wind farm company

- Shareholders experts in building wind farms
- Opportunity arises to build three wind farms in Scotland
- EIS investors brought on board



Case study: Wind farm company

- SPVs 2 and 3 are sold for £35m
- SPV 1 to be kept as long term investment
- How to get the cash out?



Substantial Shareholding Exemption ('SSE')

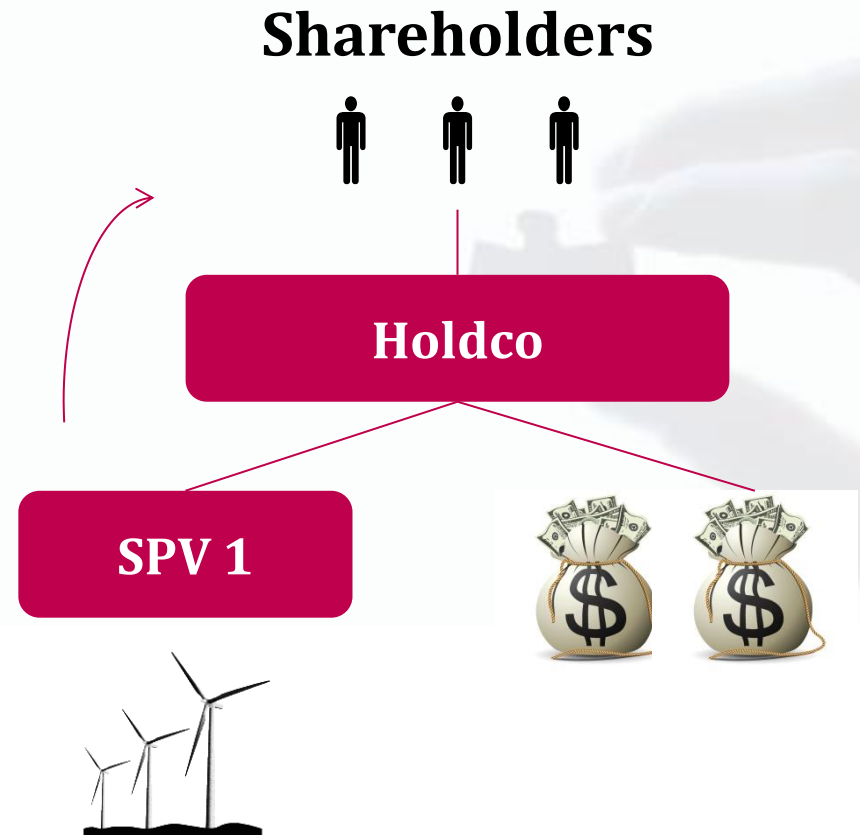
- SSE exempts gains on the disposal of companies, provided that certain conditions are met:
 - The investing company must have held a substantial shareholding in the investee company (at least 10%)
 - The shareholding must have been held for a 12 month period, beginning less than 2 years before disposal takes place
 - The investing company must be a sole-trading company, or a member of a trading group, throughout the 12 month period and immediately after disposal
- Issue: Holding of cash potentially jeopardises trading status of Holdings

Substantial Shareholding Exemption ('SSE')

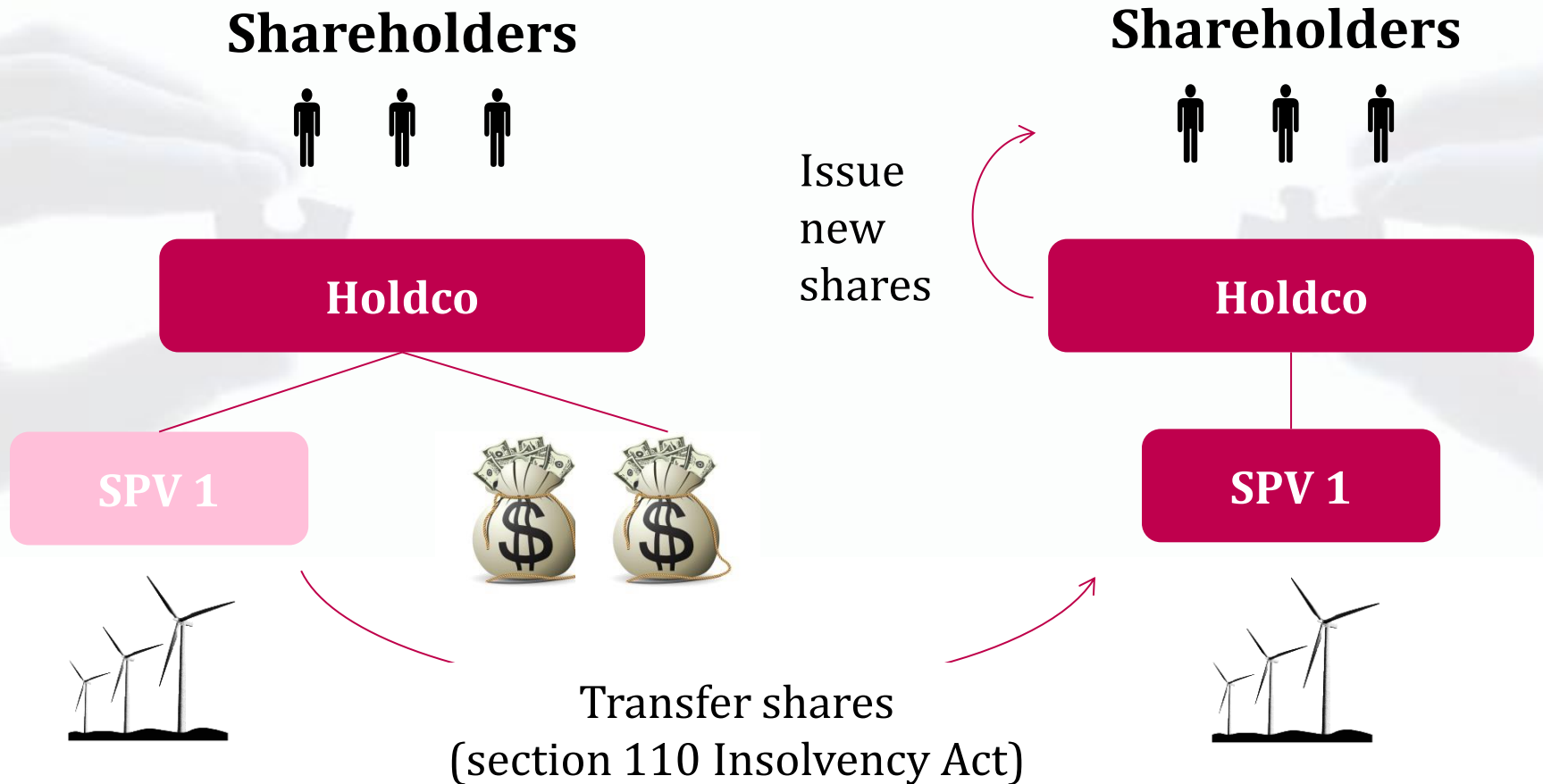
- Second subsidiary exemption:
 - SSE given if holding company liquidated within a “reasonably practicable timescale”.
 - What does this mean?
 - HMRC non-statutory Business Clearance Application
 - Take care where intermediate holding companies exist
- What to do with SPV 1?
 - Distribution in specie?
 - De-merger to Newco?
 - Sale to Newco?

1. Distribution in specie

- Capital distribution equal to market value of asset transferred (becomes base cost of shares)
- Issues:
 - Crystallises tax charge
 - No relief unless company later sold



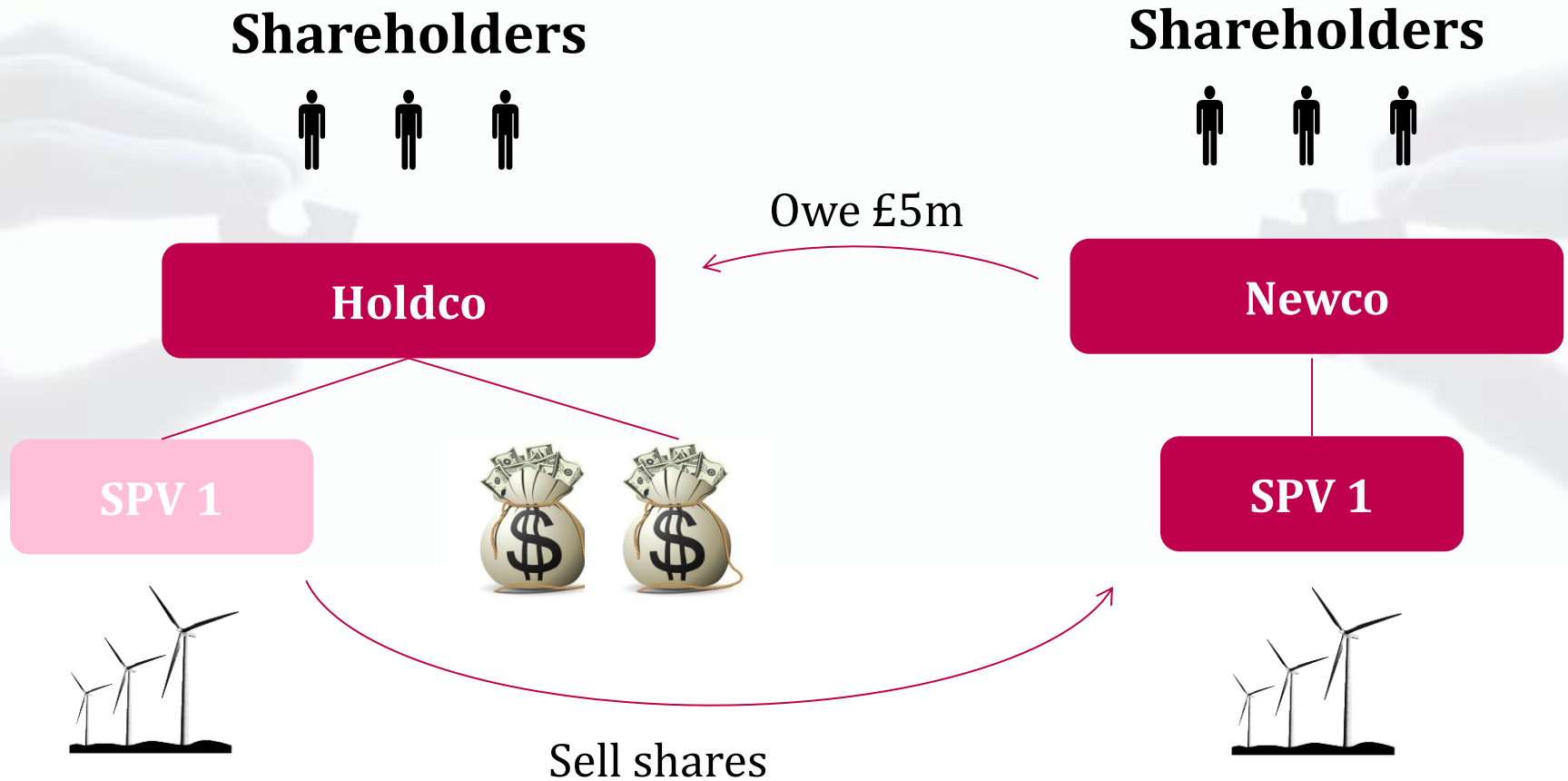
2. De-merger



2. De-merger

- Shareholders set up Newco
- Holdco transfers SPV 1 to Newco in exchange for issuing shareholders with new shares
- Reconstruction reliefs apply to treat as no gain, no loss – avoids tax crystallising
- Issues:
 - Clearances required

3. Sale



3. Sale

- Shareholders set up Newco
- Newco buys SPV 1 for £5m with proceeds left on loan account
- Debt transferred to shareholders via members' voluntary liquidation (crystallises gain, but then able to draw down funds tax free)
- Issues:
 - SSE clearance
 - Transactions in securities

Case study: Property company

- Holdco bought Propco for £2m
- Propco had owned property for several years (base cost £1m)
- Property sold for £1.5m leaving Propco redundant
- Net assets of Propco (after costs etc.) = £1.4m
- Potential corporation tax liability of £100k on sale of the property, but in reality the shareholders have suffered a £600k loss!



Solution

- Liquidate Propco in the same accounting period as the property is sold
- From 2009, under s1701A TCGA 1992, parties can elect to transfer gains/losses around group
- Loss arising to Holdco can be offset against the gain on the sale of the property



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Holdco

Propco

Gain on property: £500k
Loss on shares: £600k
(i.e. £1.4m net assets -
£2m paid for shares)

Summary

- Consider pre-liquidation planning
- Get the company in order before the liquidator is appointed
- Beware of transactions in securities / phoenixing issues

Employee Share Schemes – the benefits



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Introduction

- Why approved share schemes are still so attractive
 - opportunity to get money out as capital
 - dividends still attractive compared with salary
 - effective incentive to attract / retain key employees
- Which scheme is right for your company?
- Valuation issues
- Practical examples

Recap - approved schemes for key employees

- Enterprise Management Incentive scheme ('EMI' options)
 - *grant of options to acquire shares on a future event at a fixed exercise price (being actual market value at grant date).*
- Employee Shareholder Status ('ESS')
 - *issue of new shares worth between £2K and £50K in exchange for a forfeit of some employment rights.*
- Company Share Option Plan ('CSOP')
 - *as for EMI*

Recap - tax benefit of share schemes

- Salary & bonuses 
 - income tax at up to 40% / 45%
 - employee / employer national insurance
- Shares 
 - dividend tax rates lower than salary despite changes from 2016
 - capital on an exit 28% or 10% with Entrepreneurs' Relief

Benefits of dividends for employees despite changes to rates from 2016-17

- Dividends remain more attractive
- £5K exemption
- Abolition of tax credit
- Still a capital incentive to lock-in employees for an exit

Comparison of tax benefits - summary

	Income tax on grant, exercise or share issue	Capital gains tax on exit	Corporation tax deduction for company on exit
EMI options	nil	10% with ER *	yes
ESS	nil for first £2k	nil	no
CSOP	nil	10% with ER**	yes

** at least 12 months must have lapsed since grant of options*

***must be employee's 'personal company' (min. 5% nominal value /voting rights for at least 12 months)*

Comparison of tax benefits - summary

	Income tax on grant or share issue	Capital gains tax on exit	Corporation tax deduction for company on exit
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EMI better for company / overall?

ESS better for employee?

* at least 12 months must have lapsed since grant of options

**must be employee's 'personal company' (min. 5% nominal value /voting rights for at least 12 months)

Example: EMI and ESS tax benefits

E.g. a £10m company issuing options over 10% shares

- Current share value/exercise price £200,000
- Gain on disposal £800,000

	EMI	Employee shareholder status	<i>Unapproved share options</i>
Employee tax liability (assuming Entrepreneurs' Relief for EMI)	80,000	IT=0	360,000
Company tax saving (assume 20% rate)	(160,000)	0	(160,000)
Net tax (total)	(80,000)	0	200,000

EMI options – securing a capital benefit

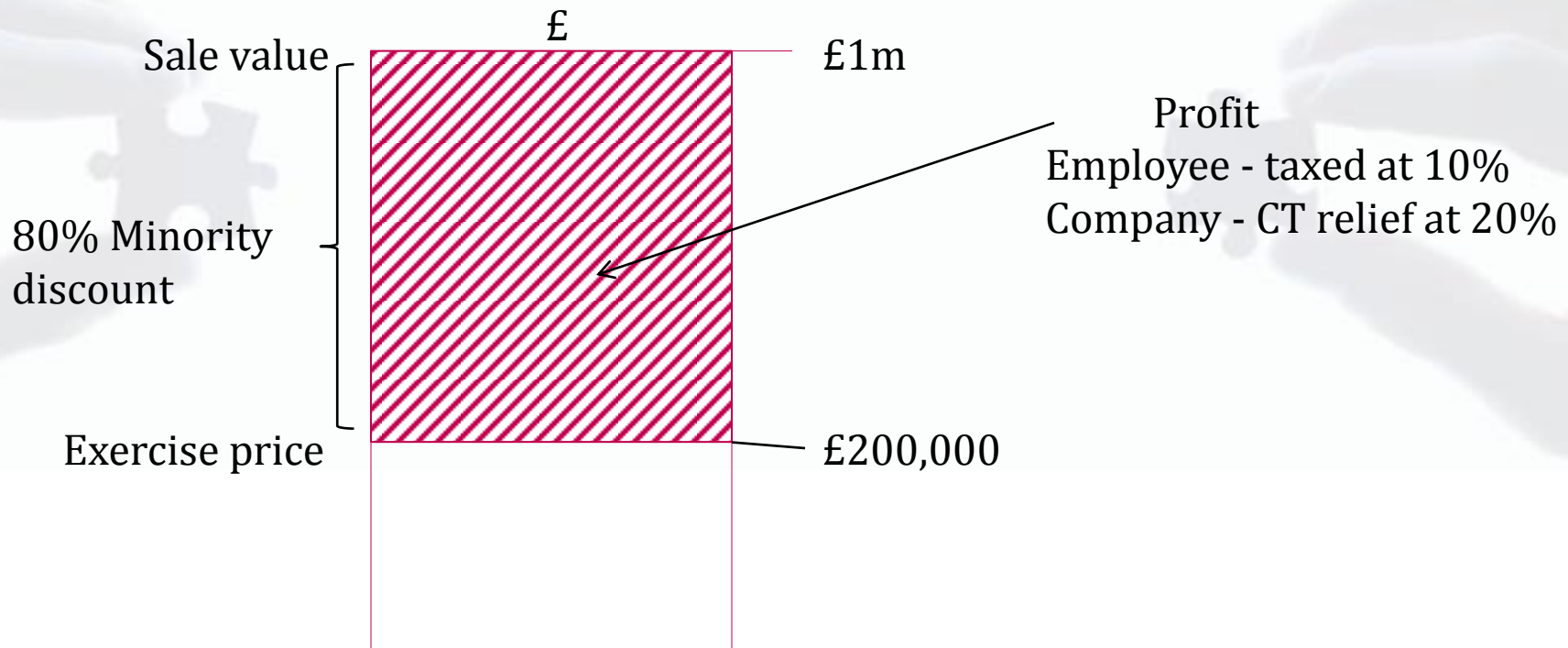
- Grant employees option to buy shares on future event at fixed price
- Exercise price = value at date of grant (i.e. today)
- Agree valuation with HMRC, up to 90% discount for minority interest
- Gain on disposal subject to capital gains tax (at 28% or 10% with ER)

Entrepreneurs' Relief (ER)

- Need 12 months from date of *grant* to sale to qualify
- No minimum shareholding requirement since April 2013
- Meet other ER requirements

EMI – maximising capital benefit

- Eg. £10m company issues options over 10% of shares



EMI commercial benefits

- Relatively cheap to set up and administer
- Flexibility if employee leaves (can let options lapse)
- Relatively straightforward to grant additional options later
- No dilution of share capital until options exercised (could be on an exit event)
- Or can allow options to vest at fixed dates and pay dividends
- CT deduction attractive to third party buyer

EMI scheme – limitations

- Stringent qualifying conditions
 - Independent, UK permanent establishment
 - Medium sized - gross assets < £30m / employees < 250
 - Qualifying subsidiaries No material interest i.e. < 30%
 - Qualifying trade. Excluded:
 - Legal / accountancy services
 - Banking / insurance / finance
 - Land / share dealing
 - Hotels, Nursing homes etc.
- No dividends until shares acquired
- Changes to Entrepreneurs' Relief rules could reduce future capital benefit

Employee shareholder status

Overview

- Forfeit of certain statutory rights (unfair dismissal & lesser)
- Value between £2,000 and £50,000 – no CGT on disposal
- Anything over £2,000 subject to income tax and national insurance on acquisition
- No material interest i.e. < 25%
- No tax deduction in company
- Complete exemption from capital gains tax on exit

Employee shareholder status

Main uses and benefits

- When EMI conditions (e.g. trading requirements) not met
- Shorter term benefits over an exit – link dividends to performance
- Lock in capital gains tax exemption – unaffected by changes to capital gains tax rates or Entrepreneurs' Relief legislation
- Psychological – employees prefer to have shares now over options

CSOPs – when are they useful?

Main uses

When EMI conditions (e.g. trading requirements) not met, or too large

Limitations compared with EMI options:

- ER on disposal only where ‘personal company’ of officer or employee
 - *at least 5% nominal value and voting rights*
 - *shares held for at least 12 months before sale*
- Maximum limit of £30,000 to each employee
- Exercise options only after 3 years (and before 10 years as for EMI)

Valuation issues – what are we using it for?

ESS

- Value at which shares are issued must be at least £2,000 (need buy back clause)?
- Income tax payable on value in excess of £2,000 only
- Capital gains tax exemption available only up to value of £50,000 on issue

EMI and CSOPs

- Value is price at which options will be exercised in future (gain = SP less ex. price)
- Agree Actual Market Value

Don't underestimate the value of minority discounts!

Don't forget about growth shares (value on day 1 = £nil or £2k)!

Valuation issues

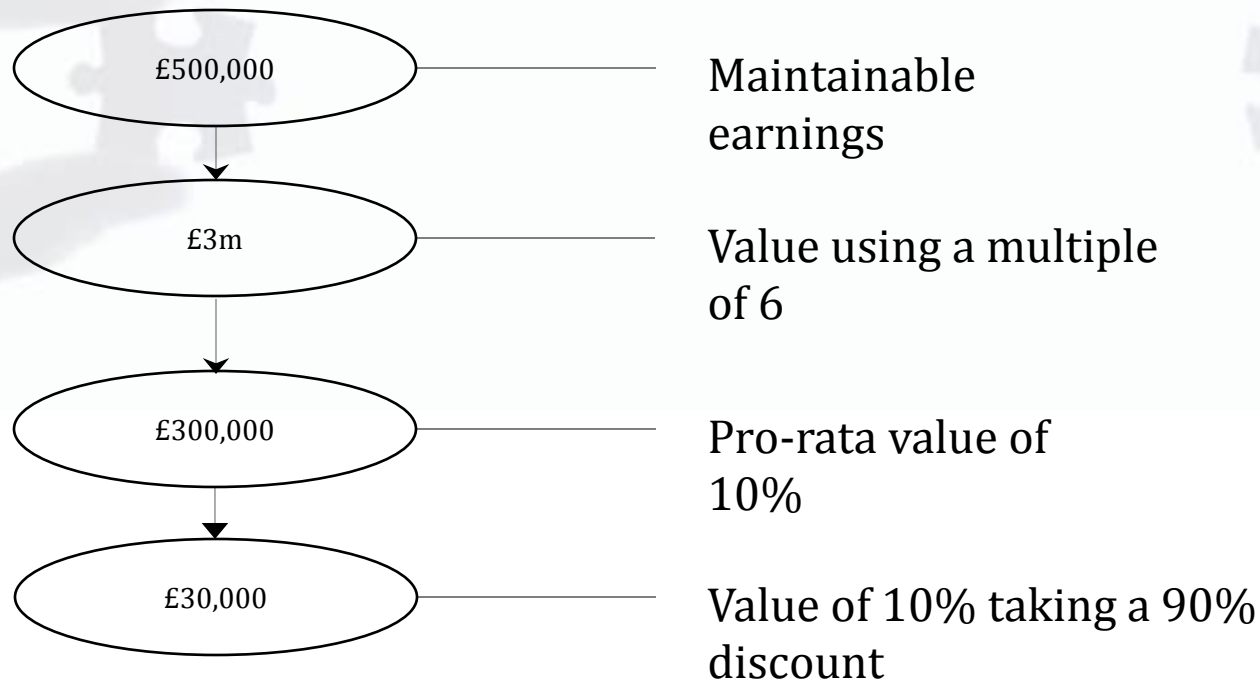
- Agree upfront (before grant/share issue) with HMRC

Typical Steps

1. Calculate 'maintainable earnings'
2. Apply suitable multiple
3. Review approach and consider net assets etc
4. Relate global value to share structure (growth shares etc)
5. Minority discounts (try for 90% discount)
6. HMRC negotiation

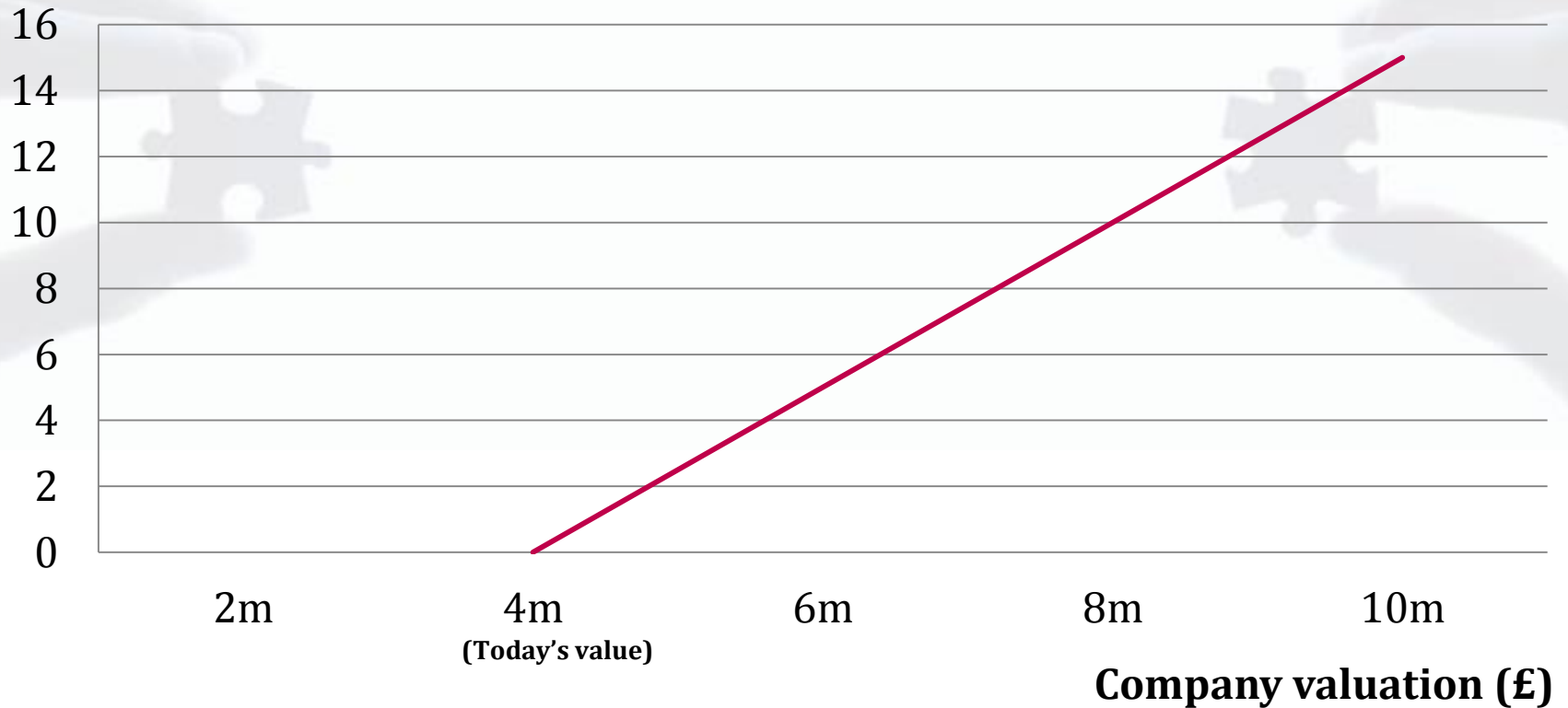
Example – valuation with minority discount

- Take trading company with ‘maintainable earnings’ of £500,000 issuing EMI options over 10% of shares.



Valuation issues – growth shares

Value per
share (£)



Valuation issues – some examples

- EMI options – some case studies
 - Importance of a robust report
 - Engineering company's interaction of EMI with EIS investment
- Employee Shareholder Status
 - Agreeing the £2k minimum value
 - Growth value shares

Thank you for listening

More information available:

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