Ask an expert

Sale of shares on retirement

Q Our clients, Mr and Mrs Mortimer, hold all the shares in a trading company, Mortimer Ltd, which they formed in 1995. It continues to be profitable, and owns some valuable plant and machinery, although it is not taking on new contracts. Mr and Mrs M formed a trading company (Mortimer Services Ltd) with their son in 2004, holding the shares equally, and it is this company which is developing into a very profitable business. The trades in the two companies are complementary, with the new company providing many of the services that are also provided by the older company. Mr and Mrs M want to reduce their involvement in the businesses, and to begin this process they have proposed that Mortimer Services Ltd ('Services') buys all the shares in Mortimer Ltd ('Mortimer'), using its own funds. They would then claim entrepreneurs' relief on the sale of the shares. In due course, they will sell their shares in Services to their son. Mr and Mrs Mortimer have asked us to confirm the tax position.

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A The sale of shares in Mortimer to Services is likely to be caught under the transactions in securities legislation in ITA 2007 Part 13 Chapter 1, as Mr and Mrs Mortimer are effectively receiving distributable reserves from Services in a capital form. If these anti-avoidance provisions apply, HMRC will issue a counteraction notice to recover tax that would have been due if the receipt had been a dividend. As a result, they would lose the benefit of entrepreneurs' relief (ER).

There are a number of ways in which this scenario could be addressed.

Mortimer could sell its plant and machinery and goodwill to Services, after which Mortimer can be liquidated. The value at which the assets are sold to Services needs to be considered. There are two aspects to the transfer of plant and machinery for tax purposes. First, for capital allowances purposes the amount paid is usually used, except where the sale is at less than market value and either the buyer cannot claim capital allowances or the buyer is a dual resident investment company connected with the seller (CAA 2001 s 61). Proceeds are limited to original cost for capital allowances purposes. Second, the capital gains tax position may need to be considered, especially if the company has large plant that has increased in value. Transactions between connected parties must be treated as made at market value (TCGA 1992 s 18).

So far as the goodwill is concerned, as the transaction is between related parties, market value must be used (CTA 2009 s 845). However, because Mortimer's trade started before 1 April 2002, Services will not be able to claim a corporation tax deduction on the amortisation of goodwill (CTA 2009 s 892), and Mortimer will be taxed under capital gains rules.

Having sold the assets and computed any corporation tax arising on the sale of its assets, Mortimer can be liquidated and the net proceeds passed to the shareholders. A straightforward liquidation should not be regarded as a transaction in securities for the purposes of the anti-avoidance provisions, following *IRC v Laird* [2003] STC 1349. This means that, as long as the relevant requirements set out in TCGA 1992 s 169I(7) are met, the shareholders should be able to claim ER.

Turning to Services, Mr and Mrs Mortimer could sell their shares to their son. Market value would apply, as the transaction is between connected parties. However, if they sell their shares at less than market value, they should be able to hold over the gift element under TCGA 1992 s 165, as long as there are no chargeable assets in the company that are not used for the purposes of the trade. If there are, there would be a restriction to the gain that can be held over, using the reducing fraction set out in TCGA 1992 Sch 7 para 7. There would be a stamp duty liability at 0.5% on the consideration paid for the shares. The family relationship would remove any exposure under the employment related securities provisions.

The real problem with this proposal is that the son has to fund the purchase out of his own resources, and in all likelihood will need to fund the purchase out of taxed income. It would be preferable to fund the purchase out of company funds, either by using a purchase of own shares or by means of an MBO structure using a new company to buy out Mr and Mrs Mortimer.

If Services purchases its own shares, the transaction can be treated as a capital gains tax transaction, as long as the purchase is for the benefit of a trade carried on by the company (for which there is some guidance in Statement of Practice 2/82), and the vendors satisfy a number of statutory requirements which are set out in CTA 2010 ss 1034 to 1048. Clearance would be sought under s 1044 to ensure that HMRC is satisfied that capital gains treatment applies to the purchase. Assuming the conditions in s 169I(6) are met, the vendors would be able to claim ER. Stamp duty at 0.5% is payable on the shares purchased and form SH03 must be stamped before it is submitted to Companies House.

If a purchase of own shares is not possible, either because it is not possible to satisfy all the requirements set out in the legislation for capital gains treatment, or because the company does not have sufficient reserves (or capital) to effect the purchase, the son could form a new company (Newco) which is used to purchase the shares in Services.

Newco would pay cash to Mr and Mrs Mortimer for their shares, and issue shares to the son in exchange for his shares in Services. The cash could be provided by loans from a bank, the son, Services or the vendors, or by way of dividends from Services. Using this route, stamp duty is payable at 0.5% on the entire value of Services, not just on the shares purchased from Mr and Mrs Mortimer.

I have outlined the main issues that should be considered in connection with the proposals, although there is a large number of other tax and commercial issues that should be addressed whenever dealing with this type of situation. ■

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